STRATEGIES FOR THE RESIDENTIAL MARKET TURN

A decade-long streak of rising prices comes to an end
Residential prices rose 576% from July 2003 to July 2018. However, this year’s decline in the Hong Kong stock market, increasing loan ratios, rising interest rates and the US-China trade war suggest that residential prices are hitting a turning point.

A downturn in the global economy could threaten Hong Kong’s residential market, as owners would become more open to negotiation and buyers would adopt a more conservative attitude. Dropping investor confidence is likely to result in a decline of residential prices. However, with a steady demand from tenants, residential rents should remain firm.

The luxury residential leasing market should be mostly immune to the downside risk, as landlords did not aggressively increase rents during the last upcycle, from Q3 2014 to Q2 2018. With a sharp decline for rents on Hong Kong Island’s luxury districts being unlikely, we recommend tenants look into other districts featuring an increasing number of properties for lease as well as new school campuses.

Summary & Recommendations

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-2.4%

Negative growth of monthly residential price index in October 2018, the greatest month-on-month drop in 34 months.

2.1%

Three-month Hong Kong Interbank Offered Rate in October 2018, the highest since December 2008.

2.9%

Hong Kong real GDP growth in Q3 2018, the slowest in eight quarters.

21%

Decline in the Hang Seng Index from its peak on 26 January 2018.

The Hong Kong residential market is facing a double hit from rising interest rates and slower economic growth due to the intensifying US-China trade tensions. While we expect residential prices to fall 3.8% in 2019 – in the most optimistic scenario, the leasing market should stay firm as rental growth has been less volatile than price growth. By mid-2019, investors should be looking at the residential market again, when the impacts of rising interest rates and trade disputes should be more apparent.

While residential rents in traditional luxury markets should stay relatively firm, tenants can search for more affordable options in other areas. The expansion of the MTR network has opened up more districts, while new office supply in Kowloon East is scheduled to outstrip that of Hong Kong Island. As companies relocate across the harbour, expatriates should begin to consider Kowloon and the New territories as places to live. They can benefit from the proximity to their workplace, as well as the new schools opening in the Kowloon East and Sai Kung Districts.

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STOCK MARKET CHANGES DRIVE BUYING SENTIMENT IN THE PROPERTY MARKET

Stocks and properties have generally been the most popular investments in Hong Kong. Given the high liquidity and the ease of the transaction process, Hong Kong’s stock market has been more volatile, reacting to economic and policy changes promptly. Therefore, the Hang Seng Index (HSI) has acted as a leading indicator, helping drive investment sentiment and prices in the property market.

Over the past decade, it has taken five to six months on average for residential prices to drop after a decline in the HSI. Learning from previous declines since 2007, the HSI declined between 33% and 59% (based on month-end figures) during previous cycles, while residential prices only declined between 4.4% and 16.6%. Although HSI has declined 21% from its peak in January 2018, residential prices are likely to slide more moderately, based on the historical corrections.

Historically, the HSI has usually hit a trough and rebounded after declining 12 to 18 months from its peak. However, it is hard to predict the direction of the stock market, which is driven by a host of different factors. Therefore, we cannot estimate property prices in Hong Kong by relying on a rough estimation of future stock prices. We must rely principally on economic data and the laws of supply and demand.
FROM BUYING TO LEASING

Traditionally, the leasing market has experienced small impacts from stock market shocks, since leasing demand strengthens when residential prices become unaffordable. According to the Census and Statistics Department, owner-occupiers have been declining as a proportion of the total number of domestic households in private sector housing. Given the aggregate demand for residential units is unchanged, more users are shifting from buying to leasing.

Owner-occupation Ratio of Private Residential Properties in Hong Kong

Source: Rating and Valuation Department; Census and Statistics Department
RESIDENTIAL RENTS SHOULD STAY FIRM AMID MARKET DOWNTURN

Hong Kong residential prices and rents tend to move together, but there is no direct evidence showing that a change in residential prices leads to a change in residential rents. However, residential rents have been less volatile given that the leasing market is driven by the end users.

We have observed that both 10-year government bond yields and residential property yields have been declining since 2008, when the US promoted its quantitative easing policy and lowered interest rates to zero. With rising interest rates and higher risk premiums, Hong Kong 10-year government bond yields look set to rise.

With cooling measures in place, the investment market has become less speculative, as a result, rents and prices have started to move closer together. Thus, it is unlikely that rents will increase alone. While we expect the record breaking run of residential price increases to end, overall residential rents should also decline in 2019, but very moderately.

The falling owner-occupation ratio for private residential units represents firm leasing demand in the market and suggests rents to remain firm.

Given a weak buying sentiment in the market together with the proposed vacancy tax imposed on new vacant flats, developers have allocated more residential properties to their leasing portfolios. For example, Sino Land announced that it will lease its new residential developments The Gage¹ in Central and The Hillside² in Wan Chai instead of offering it for sale, while Sun Hung Kai Properties announced that it will turn The Kennedy³ in Kennedy Town from a property for sale to a property for lease.

³https://www.thekennedy.com.hk/
LOWEST DOWNSIDE RISK FOR LUXURY RESIDENTIAL LEASING PROPERTIES

Although residential rents tend to be less volatile than overall residential prices, rents for luxury units in the traditional prime districts, including The Peak, Southside and Mid-levels, have been even more stable.

While a proportion of the luxury market on the Hong Kong Island has been expatriate housing, it has typically been driven by corporate profitability and staff housing allowances. With multinational companies having lowered staff housing allowances since 2011, luxury residential rent growth has remained slow. Considering that companies have changed their cost management strategies and demand shifted to more affordable luxury units after a rental slump in 2011-2014, developers holding properties for lease have become flexible and are willing to maintain rents to achieve high occupancy.

As luxury rents were not aggressively adjusted upward during the market upcycle over the past three years, luxury residential rents should have a higher potential to stay firm when the market enters a mild downcycle.

Given the brighter outlook for luxury residential rents compared to overall residential prices and rents, luxury residential leasing properties have the lowest downside risk. These rents are unlikely to surge when the market recovers, as multinational companies are likely to stay cost conscious and keep staff housing allowances as low as possible.
THE CHANGING DYNAMICS OF THE LEASING MARKET

Although global uncertainties and rising interest rates will probably weigh on business activity and household income in Hong Kong, increasing demand and the lower volatility of the residential leasing market point to a modest adjustment for the rental market in 2019. Tenants renewing their contracts in 2019, could have stronger rental bargaining power given the increasing supply of leasing properties amid a softening market. For renters looking for their next housing location, we recommend searching for better deals outside the traditional luxury districts.

Where are the other opportunities?

Looking forward, leasing demand for luxury flats is unlikely to decline significantly as Hong Kong remains attractive and competitive for MNCs’ regional headquarters. Traditional luxury neighbourhoods on Hong Kong Island continue to have the advantage as they are closer to Central, and have more international schools and better living amenities for expatriates.

However, we have started to observe changes in the market, for example, the MTR’s network expansion has led to the prosperity of more districts which are now popular with expatriates. More importantly, new office supply in Kowloon East is scheduled to outstrip that of Hong Kong Island. With companies relocating across the harbour, expatriates should consider options in Kowloon and the New Territories.

In light of the opening of three new international school campuses in Kowloon East and three in Sai Kung District in the 2018/19 school year, families are eyeing new developments in those areas. Tenants may find new flats offering greater value as residential rents in decentralised areas are cheaper than in the districts traditionally popular with expatriates.
LOOKING AT RESIDENTIAL PURCHASES IN MID-2019

With 28 months of continuous price growth coming to an end, will the current market adjustment be a healthy correction or the end of the 15-year bull run?

Under our optimistic scenario analysis, detailed on page nine, the adjustment should be brief and moderate. However, we agree with investors who are currently adopting a ‘wait-and-see’ approach, as we expect a more clear picture of where the market is heading by mid-2019.

Strategic review mid-2019 as uncertainty diminishes

Interest rates

The latest meeting minutes released by the US Federal Reserve highlighted the possibility of a review of the Federal Reserve’s strategic framework for monetary policy next year. The Fed is likely to engage with a broad range of interested stakeholders across the country and host a research conference in June 2019. The review of monetary policy could affect the pace of rising interest rates which will be reflected on the change of financing costs for property purchases.

China’s economy and capital controls

China’s economy had shown signs of slowing down due to overborrowing prior to the onset of significant US-China trade tension this year. Deleveraging, tightening liquidity, and capital outflow controls have squeezed the private sector’s economy. Oxford Economics projects China’s GDP to grow by 6.0% in 2019 due to the ongoing trade war and deleveraging, the lowest figure since 1989. Chinese measures to curb capital outflows will probably only be relaxed once China is confident that the depreciation of the renminbi has ended.

US-China trade war

The impact of the US-China trade war on the global economy should become apparent in 2019. The head of US Macroeconomics at Oxford Economics has commented that the tensions will likely escalate in 2019, and that their impact on the US economy could be sizable.\(^3\)

\(^1\)https://www.federalreserve.gov/monetarypolicy/fomcminutes20181108.htm
\(^2,3\)Research Briefing | US - G20 Summit: Trump-Xi détente, 3 December 2018
FACTORS BEHIND PRICE MOVEMENTS

Hong Kong’s residential market is open with limited restrictions. Although the government plays a key role in managing the land supply, housing demand and prices have been highly sensitive to investment sentiment and economic changes.

According to historical cycles, falling residential prices often take place during stock market and economic downturns. A tumbling stock market indicates weakening investment sentiment and contracting wealth, which results in a decline in demand and prices for properties.

In addition, we believe low real (i.e. inflation-adjusted) interest rates, low residential yields and high mortgage loan to GDP ratios are good indicators of an overheating market. These metrics help us estimate future price changes when the economy is stable.

However, residential prices and rents have a high chance of falling when the economy and market fundamentals slow. This is because the Hong Kong residential market is very sensitive to external shocks due to its strong relationship with the world’s two largest economies – the US and China.

The residential market started to fall in August 2018, as presaged by this year’s stock market downturn. Moreover, the residential market is facing the double hit of a reversal of quantitative easing and a potential economic slowdown due to the intensifying US-China tensions. We expect the decade-long streak of rising residential prices to end and prices to enter a downward cycle.

Source: Colliers; Hong Kong Monetary Authority; Rating and Valuation Department; Census and Statistics Department
Note: Price and HSI changes are based on their own quarterly peaks and troughs in subject years of downward cycles.
- Average 3M-HIBOR are the averages between the quarters of the peaks and troughs for residential prices
- Real GDP growth rate represents the lowest quarterly rates during the three downward cycles respectively
TIGHTENING POLICY DRIVES CREDIT RISK HIGHER

Interest rates in Hong Kong are effectively tied to US interest rates through the territory’s currency peg. Household borrowing in Hong Kong has been increasing since the Global Financial Crisis in 2008, as the US rolled out quantitative easing and reduced the Federal Funds rate to close to zero. The ‘zero’ nominal interest rates and ample liquidity have led to borrowing costs reaching historic lows and have increased the residential mortgage loan to nominal GDP ratio to its highest level of 47% in 2018.

With the US Federal Reserve reversing quantitative easing, Hong Kong Interbank Offered Rate (HIBOR) has been rising causing real interest rates to likely turn positive in 2019. Historically, rising real interest rates have put pressure on property prices and increased risks in the financial and property markets.

Rising costs imply a lower investment return if property yields remain low. Since local banks generally add 1.4% on top of the HIBOR-linked mortgage rate, investors may experience a negative return for their investment in 2019, if residential yields fails to rebound strongly.

High mortgage loan to GDP ratios suggest a higher risk exposure when interest rates are rising, even if real interest rates remain low by the standards of most previous decades except the last one.

Although purchasing demand should increase with population growth, buyers may delay their purchases as investment returns shrink with mounting risks due to rising interest rates.

Source: Colliers; Hong Kong Monetary Authority; Rating and Valuation Department; Census and Statistics Department
Note: 2019E refers to the timeframe of 2018 Q2 – 2019 Q2 which we expect a decline for residential prices.
Real interest rates, residential yields and 3M-HIBORs represent average quarterly figures between the peak and trough of residential prices during downward cycles in 1997, 2008, and 2015 (i.e. 1997 Q3 - 1998 Q4, 2008 Q2 - 2009 Q1, and 2015 Q3 - 2016 Q1)
POSITIVE REAL INTEREST RATES SHOULD MODERATE GROWTH RATE OF PRICES

Rising interest rates suggest higher financing costs, which should lead to weaker residential demand and a slower price growth. While mortgage rates in Hong Kong are linked either to the Hong Kong Interbank Offered Rate (HIBOR) or to HSBC’s best lending rate, property buyers have been enjoying low financing costs with HIBOR rising slowly from zero, while HSBC’s best lending rate was flat at 5.0% until it was raised by 12.5 basis points in October 2018.

Historical data shows that residential price growth has a negative relationship with real interest rates, which is an inflation-adjusted interest rate. The US Federal Reserve seems determined to cool the US economy, and despite less definitive Fed guidance about its future course, most analysts anticipate another interest rate increase in December and two to four next year. These increases will push up HIBOR correspondingly. We therefore expect real interest rates in Hong Kong to turn positive in 2019, pushing residential prices downward.

Besides the strength of the domestic economy, another factor that appears to be affecting US monetary policy considerations is the trade tensions between the US and China. Naturally, this factor also affects China’s economic outlook. The Chinese economy has been increasingly influencing Hong Kong’s economy, as indicated by the fact that both the Hong Kong and Chinese stock markets have declined since the beginning of 2018. The probable deceleration of Chinese economic growth in 2019 is another factor likely to pressure Hong Kong’s economic growth and property prices.
ECONOMY UNDER THREAT FROM US-CHINA TRADE WAR

Over the first nine months of 2018, the HSI and S&P 500 diverged for the first time in two decades. Instead, the correlation coefficient (where 1 = perfect correlation) between the HSI and Shanghai Composite Index (SHCOMP) has increased to 0.96 as of Q3 in 2018, the highest in over 20 years, suggesting Hong Kong’s stock market was increasingly influenced by China.

In terms of market capitalisation, six of the top 10 companies on the Hong Kong Stock Exchange are from mainland China1, suggesting that strong Chinese influences should continue.

Hong Kong and China both experienced slower real GDP growth in Q3 2018. The impact of US-China trade tensions has become more apparent with Hong Kong’s total exports slowing in September. Oxford Economics forecasts Hong Kong’s real GDP growth to remain low at 2.2-2.3% over the next five years compared to the government’s forecast of 3.2%2 in 2018. It also forecasts China’s real GDP growth to decelerate for five years in a row from 6.5% in 2018 to 5.0% in 20233.

While slower growth seems likely in Hong Kong and China, labour markets should remain firm if the US can maintain its current growth. However, if the US-China trade war tensions intensify and contribute to a slowdown in both the US and the global economy, we believe the negative impact on the Hong Kong residential market to be substantial.

Conversely, faster than expected US growth is also a risk for Hong Kong, since interest rates would probably be pushed up rapidly, threatening residential price growth in 2019 and beyond.

1 HKEX Fact Book 2017
2 Economic Situation in the Third Quarter of 2018 and Latest GDP and Price Forecasts for 2018, 16 November 2018
3 Oxford Economics Global Economic Databank
THREE SCENARIOS FOR RESIDENTIAL PRICE MOVEMENTS

As we believe that residential prices will be mainly affected by two factors – rising interest rates and moderating economic growth, the correction of residential prices will likely depend on the intensity of these factors.

**Core Scenario**


- **Local economy:** a mild deceleration in 2019, but maintains growth over 2% thereafter according to the forecast by Oxford Economics.
- **Real interest rates:** to turn positive in 2019 but remain low.
- **Implications for residential prices:** To decline 15% between Q2 2018 and Q2 2019, and to recover in H2, concluding a 3.8% decline in 2019.

Beyond 2019, the pressure on residential prices should fade, keeping them stable in 2020 and regaining upward momentum in 2021 if the global economy stabilises.

**Negative Scenario**


- **Local economy:** slower than expected (i.e. 1.5%-2.0%) growth in 2019, staying low in 2020 and followed by a mild recovery in 2021.
- **Real interest rates:** to turn positive in 2019 but staying very low.
- **Implications for residential prices:** This scenario suggests residential prices continue their slide in H2 2019 due to the sluggish economy, causing a significant 15% decline for the whole year. Price growth over the next five years would depend on when the combined impact of lower prices and continuing low real interest rates started to outweigh concerns about the economy.

**Very Negative Scenario**

Situation: US-China trade war to escalate sharply, contributing to a US recession in 2020 and a significant deceleration in the global economy.

- **Local economy:** very slow growth (i.e. 1.5% or below) in 2019, followed by further deceleration in 2020 and 2021.
- **Real interest rates:** to hover at zero as in 2019 there would probably be only one increase in the Federal Funds rate in the US.
- **Implications for residential prices:** Residential prices to fall sharply, mirroring the declines in residential prices of more than 15% during the economic downturns in 1997 and 2008. In this case slowdown in the world’s two largest economies would cause residential prices to slump 20% or more. The long-term price movement would be hard to forecast.
## CORE SCENARIO

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