

ECONOMIC FOCUS

Treasury Division



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Hong Kong Housing Market: No Bubble Yet

Underpinned by strong influx of liquidity, property prices climbed nearly 25% from the trough hit in December 2008, when the Hong Kong economy was mired in recession. Luxury home prices have surpassed the 1997-peak, and prices in the mass market have also been surging.

Both the price-to-rental and price-to-income ratios of mass market units are about 50% higher than the historical averages, suggesting an overvalued market. Nevertheless, other indicators, including speculative activities, leverage ratios and future price expectations, suggest that the housing market cannot yet be called a bubble.

Investment demand driven by the influx of liquidity has been the key factor fuelling the recent property market rally. Future demand will depend on whether foreign funds will continue to flow into Hong Kong, which in turn is mainly reliant on how fast central banks in the advanced economies and mainland China exit their ultra-loose monetary policy. With the global recovery remaining fragile, it might be difficult for the US and European central banks to withdraw monetary stimulus in the near term.

It is widely believed that property prices could rise further, as new supply is expected to be fairly tight, and new marginal buying activities from both investors and end-users will likely be sustained. Nevertheless, the expected price gains would probably be more moderate, as liquidity conditions are likely to be less excessive as some Asian policymakers have started the normalization process.

Exhibit 1

| | 2009 | 2010 Outlook |
|----------------------------|---|--|
| Demand | Strong | Moderate |
| Speculators | Low | Low |
| Investors | Strong | Moderate |
| Mainland investors | Strong | Moderate |
| Overseas investors | Strong | Moderate |
| Local investors | Strong | Moderate |
| End-users | Strong | Moderate |
| Supply | Very tight | Less Tight |
| Newly completed units | Very tight | Less Tight |
| Completed and unsold units | Very tight | Less Tight |
| Price | Rise sharply +25% from Dec08 | Rise moderately +10% from Dec09 |

Source: Hang Seng Bank



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Housing Market under the Spotlight

Residential property prices have been surging while the Hong Kong economy was in recession. Prices climbed nearly 25%¹ from the trough hit in December 2008, recouping all the losses suffered as a result of the financial crisis. Larger-sized units recorded bigger gains, with some having surpassed their 1997 peaks, while those at the lower end of the market are still some 25% below.

Even the Hong Kong Monetary Authority is on its guard, as it requested banks to lower the loan-to-value ratio for residential properties priced at HKD20 million or above, the so-called luxury homes, from 70% to 60%. The Hong Kong SAR government also said that it would try to refine its land policy to ward off a bubble.

Exhibit 2

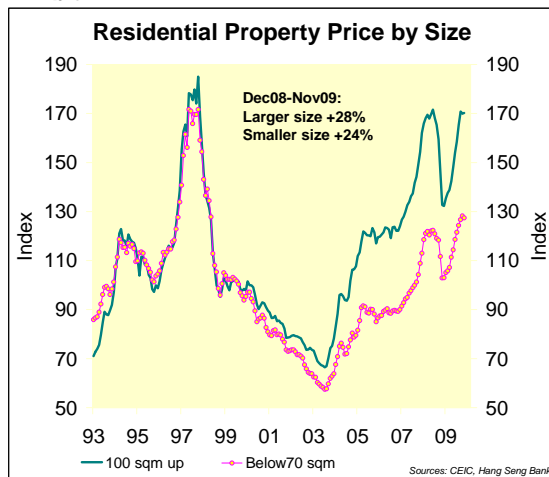
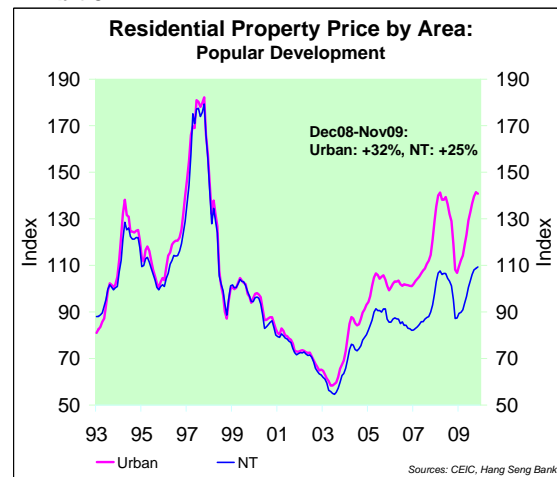


Exhibit 3



Bubble Symptoms: Some but not Widespread

Is there a bubble? A housing bubble may be defined loosely as a sharp rise in property prices, generating expectations of further increases, attracting buyers or speculators who are interested in making a quick profit from short term buying and selling of properties. This further drives up demand and prices to unjustifiable levels. Checking the key bubble symptoms, namely overvaluation, speculative activities, leverage scale and expectations for future price gains, against historical averages and the 1997-peak levels show that while prices are high, other indicators are yet to reach alarming levels.

Exhibit 4

| Bubble Symptoms | Severity Level | |
|------------------------------------|----------------|--------|
| | 1997 | 2009 |
| Overvaluation | High | High |
| Speculative activities | High | Low |
| Leverage | High | Low |
| Expectations of future price gains | High | Medium |

Source: Hang Seng Bank

¹ Changes throughout the report are on year-on-year basis unless otherwise stated.



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Overvalued Housing Market

Price-to-Rental Ratio Backs to 1997-Peak Level

Are property prices too high? The price-to-rental ratio provides one of the yardsticks to gauge whether housing is priced at fair value.

For instance, the price-to-rental ratio for a 1,500 square feet flat (the so-called luxury home) located on Hong Kong Island was 40.2 in September 2009, meaning that it would take over 40 years for the property investment to break even disregarding interest and other expenses. The ratio was 42% higher than a reading of 28.3 during the 1997-peak and 122% above its 1982-2009 historical average of 18.1.

The situation is not any better in the mass market. Take the price-to-rental ratio of a 600 square feet flat located on Hong Kong Island as an example, the latest reading is not only back to the 1997-peak, but is also 53% higher than its historical average.

Exhibit 5: Luxury Segment

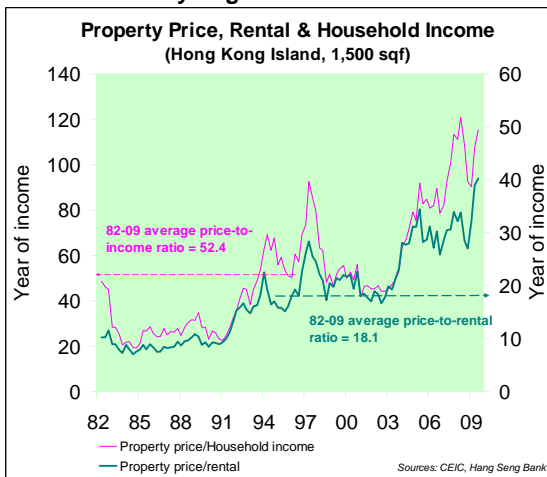
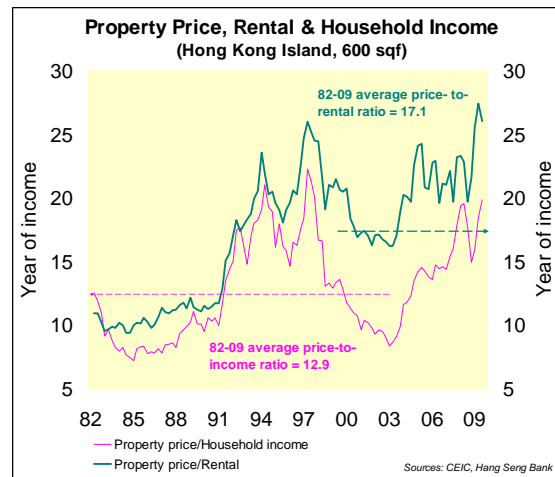


Exhibit 6: Mass Market



Housing Price-to-Income Ratio is Not Too Far Below 1997 Bubble Market

Another useful check on property market valuation is the housing price-to-income ratio. Again, the luxury segment looks bubbly. For instance, the price-to-income ratio of a 1,500 square feet flat located on Hong Kong Island was 115.3 in September 2009, meaning that the price of such a flat is equivalent to over 115 years of an average household's income. The ratio was 24% higher than that prevailing during the 1997-peak and was also 120% above its historical average.

Conditions in the mass market might look less bubble-like, but prices in the sector are not inexpensive by historical standard. For instance, the price-to-income ratio of a 600 square feet flat located on Hong Kong Island was 19.8 in September 2009, not too far from a reading of 22.3 during the 1997-peak and was 54% above its historical average ratio of 12.9.



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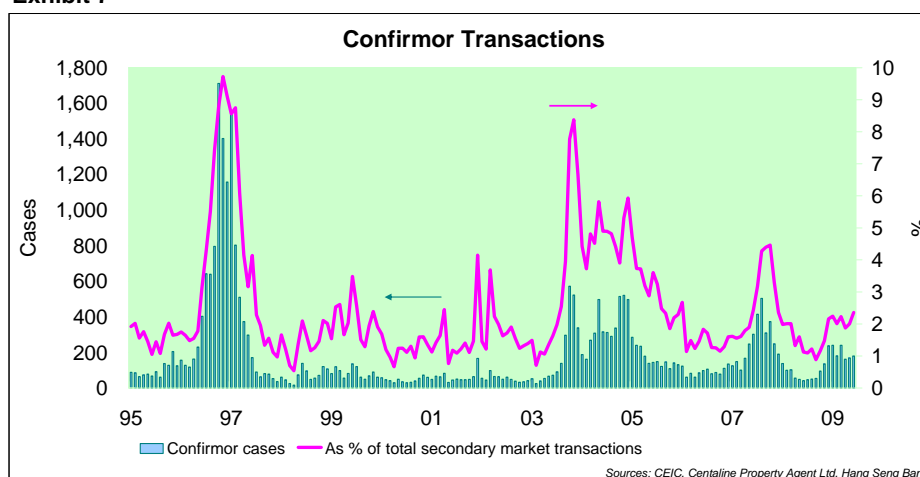
Low Speculative Activities

Unlike previous property market cycles, speculators may not be the main force pushing property prices higher in the latest rally, as indicated by the relatively low level of confirmor transactions.

According to data provided by a local property agency Centaline, the number of confirmor transactions rebounded after hitting a trough in the first quarter of 2009, rising from an average of 50 cases per month to about 200 in the second half, which was about one-tenth of the 1997-peak level of over 1,700 transactions per month.

As a percentage of all secondary transactions, confirmor transactions were steady at about 2% in the last six months. Again, the figure is far below that of the 1997-peak level of 9.7%.

Exhibit 7



Low Financial Leverage

Leverage or rapid credit expansion is not the major forces behind the property rally either. The banking sector's Hong Kong dollar currency loan-to-deposit ratio was merely 70% as of September 2009, much lower than the 1982-2009 historical average of 110% and the 1997-peak of 130%.

Banks' property-related loan portfolio expanded at a mild pace of about 3% in the first three quarters of 2009 and the overall loan portfolio actually contracted. Corresponding figures for the 1997 period when property prices peaked were 43.2% and 30.7% respectively.



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Exhibit 8

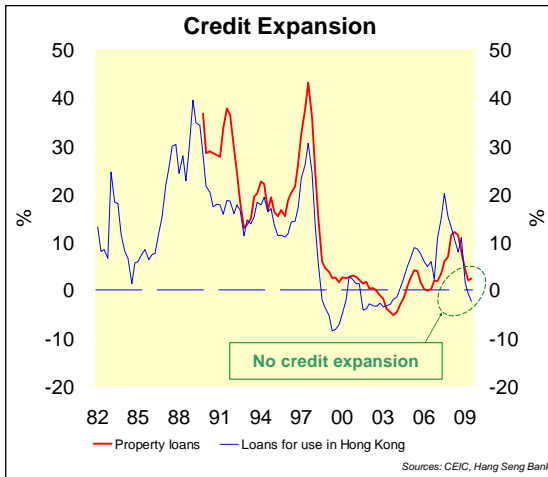
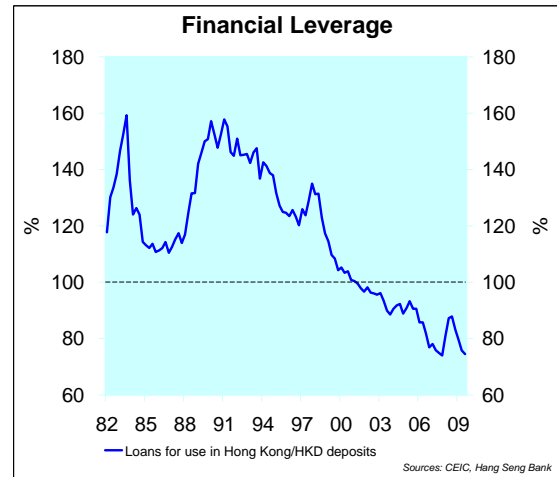


Exhibit 9



Strong Investment Demand

Massive Influx of Liquidity

Investment demand driven by the influx of liquidity has been the key factor fuelling the recent property market rally. Hong Kong has experienced strong inflows of capital to bet on mainland China's better economic prospects and in search of higher yielding assets, as evidenced by the rise in the aggregate balance of the banking sector and the issuance of additional Exchange Fund Bills. Between August 2008 and November 2009, the aggregate banking balance and value of outstanding Exchange Fund paper increased over HKD640 billion, equivalent to about 36% of GDP.

Exhibit 10

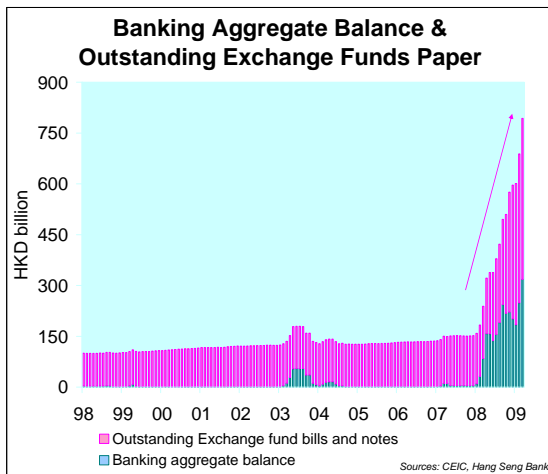
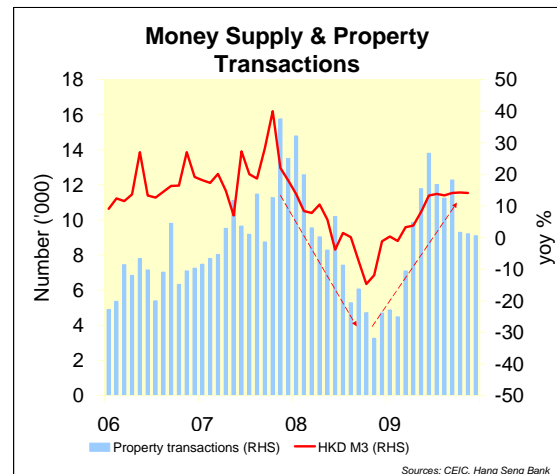


Exhibit 11



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Excess Liquidity Chases Higher-yielding Assets

Given a near zero interest environment, investors are attracted by the positive yields and expected capital appreciation potential of the local property market. Property market yields have been stable at around 4%-5% in the last two decades. Investors' borrowing costs or mortgage rates have been falling and are currently low at about 2%. The flow of funds toward the property market took prices and transactions back to levels prevailing before the financial crisis.

Exhibit 12

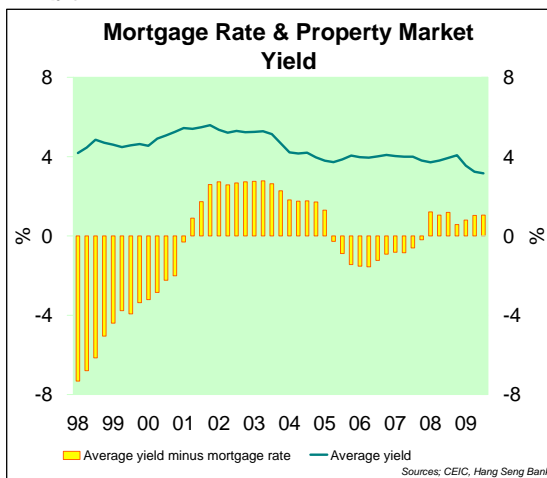
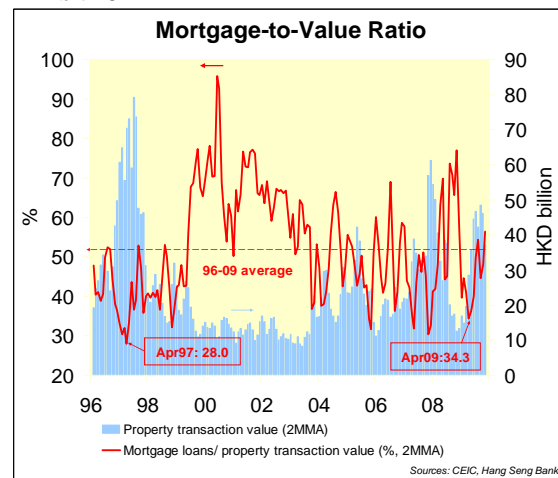


Exhibit 13



Mainland China Buyers are Active Players

Among foreign investors, those from mainland China are likely to be the most active. Some claimed that purchases made by this group sometimes accounted for some 30% to 40% of transactions in a number of luxury segment property projects and many of these deals were settled in cash without the need of mortgage loans. This trend can also be seen by a low mortgage-to-value ratio during most of 2009 relative to historical averages.

Monetary Policy Starts to Normalise

Would foreign funds continue to flow into Hong Kong? Much depends on how fast major central banks exit their ultra-loose monetary policy. With the global recovery remaining fragile, it might be difficult for the US and European central banks to withdraw monetary stimulus in the near term. The situation in this region, however, is slightly different. The Reserve Bank of Australia has surprised market by an earlier-than-expected interest rate hike in the final quarter of 2009. In mainland China too, the People's Bank of China, has stepped up efforts to tighten liquidity, including raising banks' reserve requirement ratio by half a percentage point as well as increasing the yield on central bank bills.



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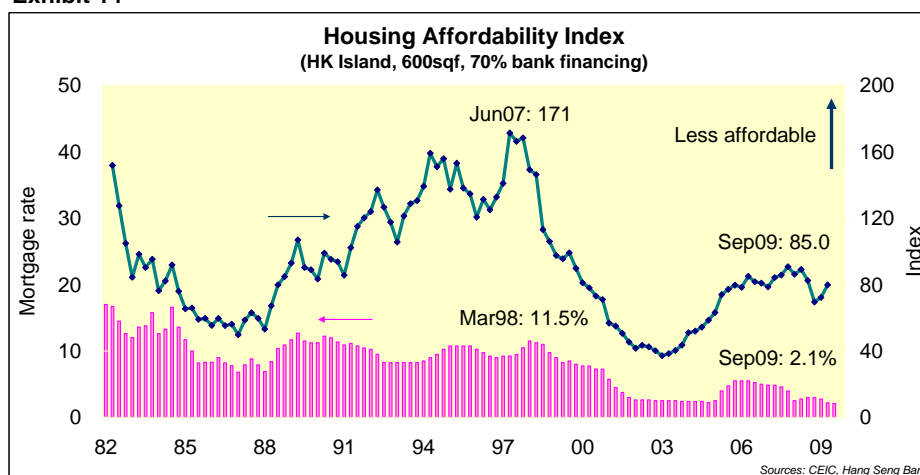


Strong End-Users Demand

Favourable Affordability Underpinned by Low Interest Rates

End-user demand has been strong due to favourable housing affordability, as interest rates are at historical low levels and banks have been aggressive in mortgage pricing.

Exhibit 14



Housing Affordability May Deteriorate

Housing affordability will remain favourable if interest rates stay low for a while longer, but may deteriorate sharply when interest rates revert to an uptrend. For instance, if mortgage rate rises to 6% from around 2% at present, affordability would be eroded by about 40%.

Exhibit 15: Housing Affordability Scenarios (600 square fleet flat located on Hong Kong Island)

| Mortgage rate | Housing Affordability Index | Deterioration in Housing Affordability |
|--|-----------------------------|--|
| 2.1% (3Q09) | 84.3 | --- |
| Other things equal, if mortgage rate rises to | | |
| 3.0% | 91.5 | 8.6% |
| 4.0% | 100.0 | 18.7% |
| 5.0% | 108.9 | 29.2% |
| 6.0% | 118.3 | 40.3% |
| 7.0% | 128.0 | 51.8% |
| 8.0% | 138.1 | 63.8% |
| 9.0% | 148.5 | 76.2% |
| 10.0% | 159.3 | 89.0% |

Source: Hang Seng Bank



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Record Low Supply

Property prices made new highs in 2009, as supply was perceived to be very tight. Some 15,000 units were bought in the primary market during the year, but the completion of new units dropped to a multi-decade low of 7,200 in the same period.

Property developers filled the shortfall from previously-completed but unsold units, resulting in a sharp rundown of inventories, enabling property developers to charge premium prices. The number of completed but unsold units was driven down substantially to a record-low of 8,000.

Exhibit 16

| | Commenced units | Completed units | Accumulated completed & unsold units at end of year |
|-------|-----------------|-----------------|---|
| 2003 | 14,100 | 26,400 | --- |
| 2004 | 14,000 | 26,000 | 15,000 |
| 2005 | 15,000 | 17,300 | 16,000 |
| 2006 | 17,300 | 16,600 | 19,000 |
| 2007 | 12,900 | 10,500 | 10,000 |
| 2008 | 8,000 | 8,800 | 10,000 |
| 2009 | 8,200 | 7,200 | 8,000 |
| 2010F | --- | 12,600 | --- |

Sources: Rating & Valuation Department; Housing & Transport Bureau, CEIC, Centaline Property Agency Ltd, Hang Seng Bank

This year's new supply is expected to increase to about 12,000 units. While this number is 50% higher than the annual supply of about 8,000 in the previous two years, it is still well below past trends.

The dearth of land sales in 2008 and 2009 would also mean total supply of housing units in the next few years would be on a downtrend, as it takes three to five years from land sales to completion of a project.

Expected Future Price Gains

The future landscape will depend very much on the interplay of forces between demand and supply, the timing and scale of how global policymakers are going to mop up excess liquidity, as well as the local government's land and housing policy.

It is widely believed that property prices could rise further, as new supply is expected to be fairly tight, and new marginal buying activities from both investors and end-users will likely be sustained, underpinned by a liquidity-rich environment.

Nevertheless, the expected price gains would probably be moderate, as liquidity conditions are likely to be less excessive, as some Asian policymakers have started the normalization process.



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