ECONOMIC FOCUS
Treasury Division

Irina Fan
Senior Economist
irinafan@hangseng.com

Joanne Yim
Chief Economist
joanneyim@hangseng.com

2 April 2009

Hong Kong's Residential Property: Nearing the Trough?

The recent property market data for the residential sector are generally positive, suggesting that the property market may be at or near its cyclical trough. Property prices edged up slightly after a freefall; transactions rebounded from historic-lows; market sentiment improved and banks are more willing to make mortgage loans at aggressive pricing.

The Hang Seng Property Index, a leading indicator of the residential property market in Hong Kong, also seems to suggest that property prices may soon find a bottom.

However, it may be too soon to be overly optimistic, as property prices tend to fluctuate in tandem with economic performance and it is quite clear that the near-term economic outlook is bleak. We expect Hong Kong's real GDP to contract 3% this year and the unemployment rate rise to a peak of about 7%, averaging 6.3% in 2009.

With job losses mounting and income falling, property prices are likely to come under pressure, although the relatively tight future supply and favourable affordability should provide some buffers.

We believe sustainable recovery is out of reach until the global economy and financial system is fully repaired, which would seem to be inconceivable in the near-term. As such, we expect Hong Kong's residential property price to decline 18% in 2009, which implies another 13% drop from the present level.

Freefall in Property Prices Come to a Halt

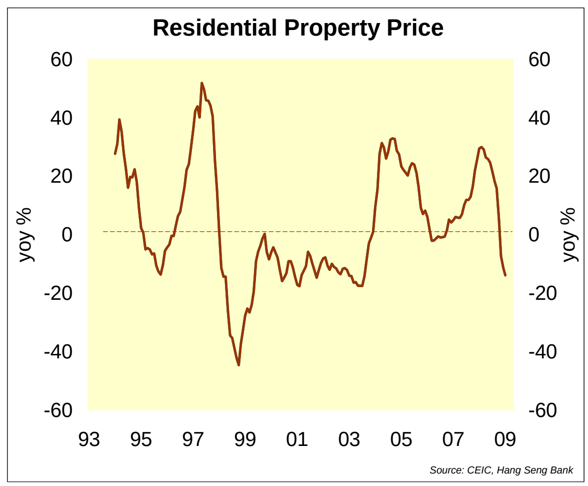
The residential property market had a notable pullback in the second half of 2008 after a sharp rally. Prices swung from a 27.5%[1] increase in the first six months of 2008 to double-digit decline in the last few months.

The freefall bears some resemblance to the situation in 1997-98, which marked the beginning of a six-year property market downturn, raising fears of a return of a prolonged bear market. At the SARS trough, property prices plunged 70% from the October-1997 peak, pushing about one-in-five mortgages into negative equity.

However, the first two months' property market data seem to show early signs of stablisation. Property prices edged up slightly, transactions rebounded from historically low levels and market sentiment improved. The property market looks more resilient this time. What has made the difference?

Exhibit 1

Exhibit 2



The Past and the Present Cycle

Polarised Market

Compared with previous property cycles, price fluctuation has been more pronounced at the luxury-end of the market, perhaps reflecting more investor activities. For instance, the price of luxury housing rose 158.2% from July 2003 to June 2008, and then fell 11.6% in the final quarter of 2008, while changes in the mass segment were 112.9% and minus 2.7% in the corresponding periods.

The increasingly polarised market has resulted in widening price gap between smaller and larger sized flats. The price gap between urban and new territories units also grew over the last five years.

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

Exhibit 3

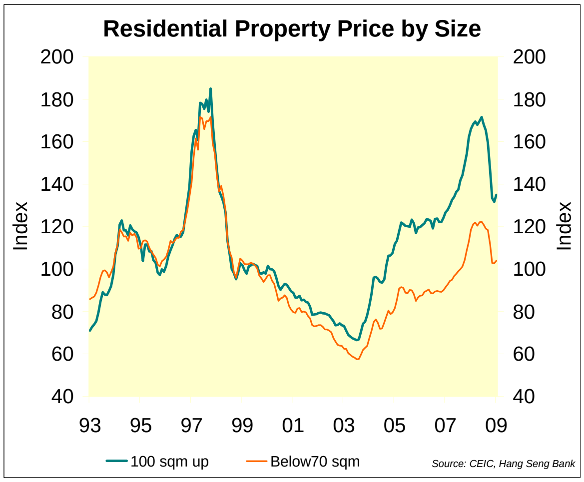
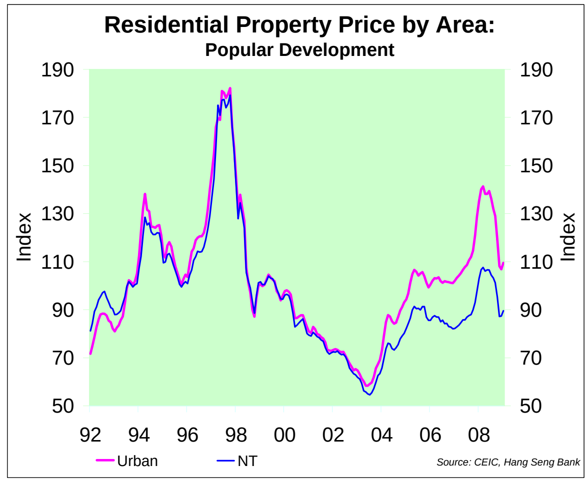


Exhibit 4



End User-Dominant Market

Another feature of the present market is relatively low level of speculative activities. A common measure of speculative activitives is the number and proportion of confirmor transactions. According to data from Centaline Property Agency, the number of confirmor transactions shrank sharply from over 400 cases in the first quarter of 2008 to about 50 in the first two months of 2009. The latter accounted for only about 1% of all secondary transactions, similar to the 2003-trough.

Speculative activities were relatively low even at the recent peak. The share of confirmor transactions once climbed to 4.5% in April 2008. The figure remained far below that of the 1997-peak level of 9.7%, indicating an end user-dominant market.

Exhibit 5

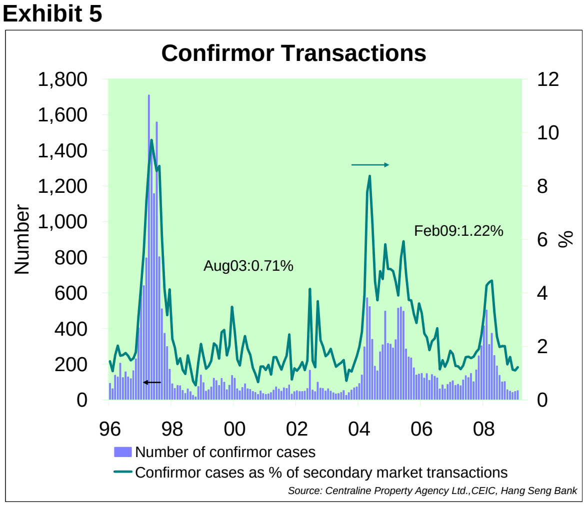
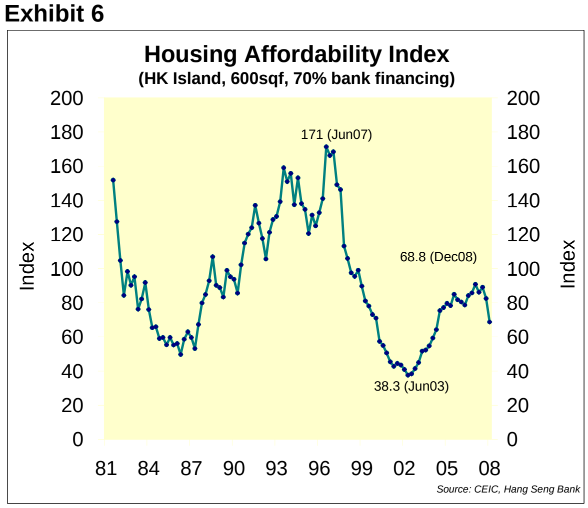


Exhibit 6



More Affordable Housing

The solid end user demand is underpinned by more affordable housing especially after the recent price decline. For instance, the affordability index, as measured by the ratio of the monthly mortgage payment to household income, of a 600 square feet flat located on Hong Kong Island has improved from about 90 to below 70 (a lower number indicates improved affordability), which was about 40% below the 1997 peak.

More Accessible to Bank Loans

Mortgage lenders raised the bar to property loans after the credit crisis deteriorated in August 2008. More recently, however, banks are more willing to make mortgage loans, as the credit market condition has stablised. For instance, the value of new mortgages approved has been on an uptrend, rising 34.6% to HKD11.4 billion in February 2009 from HKD8.5 billion in November 2008 after flat prices fell.

Mortgage plans are also being offered at more aggressive pricing, reversing the trend of mortgage rate hike in the last quarter of 2008. The proportion of new loans approved at more than 1.75% below the best lending rate rose to 54.5% in February, from 23.8% in November 2008.

There is also an upward trend on HIBOR-based mortgages, as interbank rates are at low levels. The proportion of new approvals priced with reference to rates other than the best lending rate rose to 32.0% from 3.8% over the same period.

Exhibit 7: Interest Margin on New Loans Approved During the Month

	Feb09	Jan09	Dec08	Nov08	Oct08
Best lending rate (BLR)					
BLR minus (2.25% or up)	3.0%	1.8%	5.8%	15.0%	70.0%
BLR minus (1.75% to 2.25%)	51.5%	39.6%	40.3%	8.8%	17.7%
BLR minus (up to 1.75%)	12.7%	29.4%	34.8%	64.7%	7.2%
At BLR	0.5%	0.3%	0.7%	0.9%	0.7%
Above BLR	0.3%	0.5%	0.7%	1.6%	0.6%
Fixed rate	0.0%	0.0%	0.0%	0.0%	0.0%
Others	32.0%	28.4%	17.7%	9.0%	3.8%

Source: Hong Kong Monetary Authority, Hang Seng Bank

Have Property Prices Found the Bottom?

Prices Start to Stabilise

The Centa-City Leading Index, which measures secondary market transactions, has been rising for three consecutive weeks, reaching an 18-week high of 59.7 in mid-March, indicating a slight rebound of property prices to the early November 2008 level when the sharp correction began. The Hang Seng Property Index, another leading indicator of the property market, also seems to suggest that property prices may soon find the bottom.

Exhibit 8: Centa-City Leading Index

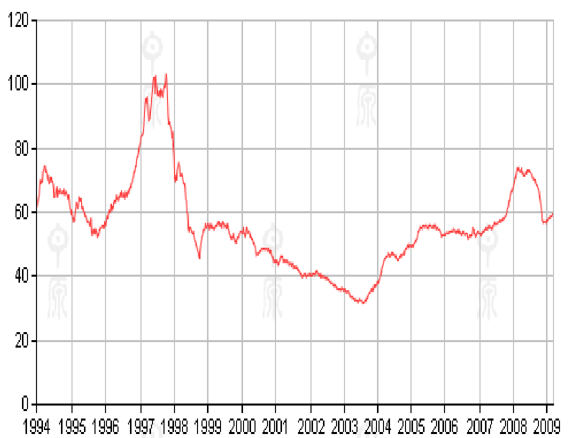
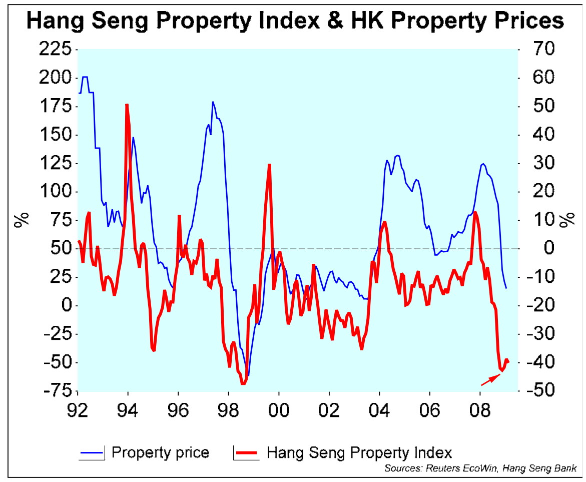


Exhibit 9



Source: Centadata, Hang Seng Bank

Demand is Low, but Supply Remains Tight

Demand has dropped substantially due to the weak economic conditions. Only 11,046 units were bought in the primary market in 2008, down 45% from 2007. But, supply also shrank to a three-decade low of about 10,000 new units. The housing inventory, another commonly used measure to gauge availability of housing supply, was also at relatively low level. Housing inventory was equivalent to 6.6 months of supply at the prevailing sales pace at end-2008, compared with 11.5 months in the 2003-trough.

Looking ahead, new supply is estimated to rise. The government projects an average of about 12,000 new units to come onto market each year for 2009 and 2010. While this number is higher than the annual supply of about 10,000 in the previous two years, it is still well below past trends.

Exhibit 10

	Completed units	Primary market transactions	Add to/run down on existing stocks	Accumulated completed & unsold units at end of year
2003	26,397	26,498	-101	---
2004	26,040	25,694	346	15,000
2005	17,320	15,994	1,326	16,000
2006	16,580	13,986	2,594	19,000
2007	10,470	20,123	-9,653	10,000
2008	8,780	11,046	-2,266	10,000
2009F	**14,740**	---	---	---
2010F	**12,600**	---	---	---

Source: CEIC, Hang Seng Bank , Census and Statistics Department

Exhibit 11

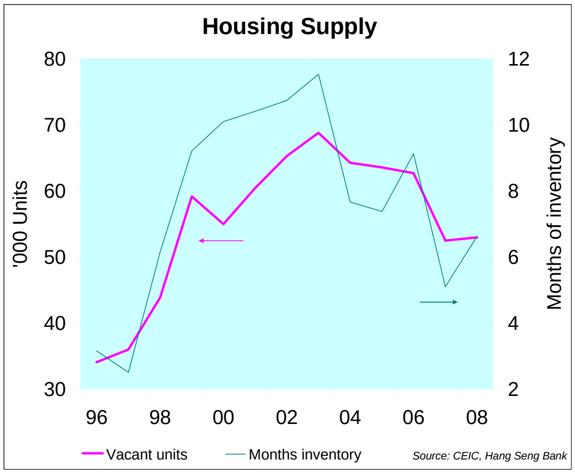
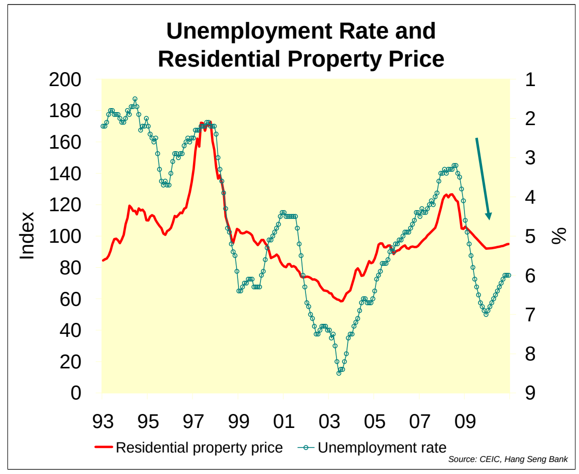


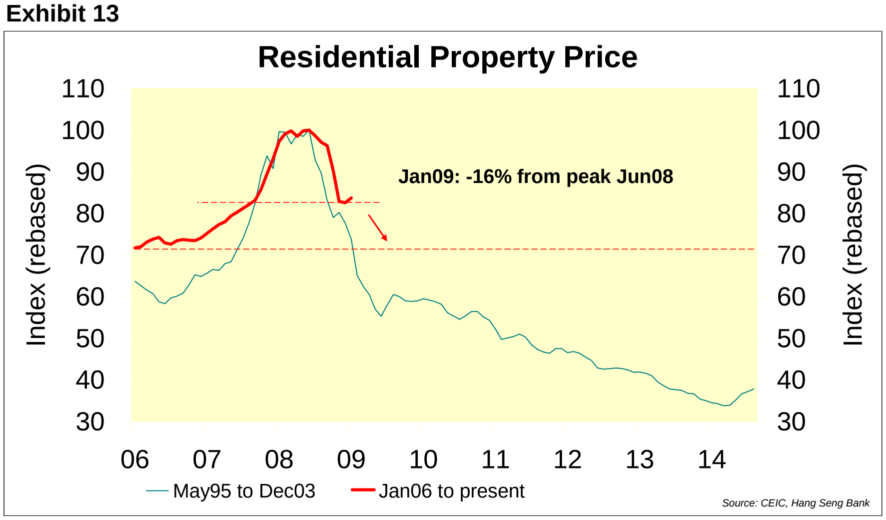
Exhibit 12



Our Forecast: We are Less Optimistic

There are some positive developments in the property market, which may likely be temporary. Property price also tends go up and down in tandem with economic performance and it is quite clear that the near-term economic outlook is bleak.

Exhibit 13



For instance, property prices lost momentum in the third quarter of 2008 when the economy experienced a sharp downturn, reflecting the adverse impacts of the global financial tsunami. Hong Kong's real GDP growth slowed to a five-year low of 1.7%, the lowest since 2003 when the local economy was plagued by the SARS crisis. In the last quarter of 2008, recession in Hong Kong deepened with GDP shrinking 2.5% on a yearly basis, triggering a sharp correction in the property market.

We see Hong Kong's real GDP contract 3% in 2009 and the unemployment rate rise to a peak of about 7%, averaging 6.3% in 2009. With job losses mounting and income falling, property prices are likely to come under pressure, although the relatively tight supply and favourable affordability should provide some buffers.

We believe sustainable recovery is out of reach until the global economy and financial system is fully repaired, which may seem to be inconceivable in the near-term. As such, we see Hong Kong's residential property price decline 18% in 2009, which implies another 13% drop from the present level.

Exhibit 14: Residential Property Prices and Economic Performance

	Real GDP (yoy %)	Unemployment rate (s.a. %)	Property Prices (yoy %)
1997	5.1	2.2	39.5
1998	-6.0	4.7	-28.2
1999	2.6	6.3	-14.6
2000	8.0	5.0	-10.4
2001	0.5	5.1	-12.2
2002	1.8	7.3	-11.1
2003	3.0	7.9	-12.0
2004	8.5	6.8	26.7
2005	7.1	5.8	18.0
2006	7.0	4.8	0.7
2007	6.4	4.0	11.7
2008	2.5	3.6	16.4
2009F	-3.0	6.3	-18.0

Source: Census and Statistics Department, CEIC, Hang Seng Bank

Disclaimer

This document has been issued by Hang Seng Bank Limited ("HASE") and the information herein is based on sources believed to be reliable and the opinions contained herein are for reference only and may not necessarily represent the view of HASE. The research analyst(s) who prepared this report certifies(y) that the views expressed herein accurately reflect the research analyst's(s)' personal views about the financial instrument or investments and that no part of his/her/their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report. Nothing herein shall constitute as offers or solicitation of offers to buy or sell foreign exchange contracts, securities, financial instruments or other investments. Re-distribution of any part of this document by any means is strictly prohibited.

The information contained in this document may be indicative only and has not been independently verified and no guarantee, representation, warranty or undertaking, express or implied is made as to the fairness, accuracy, completeness or correctness of any information, projections or opinions contained in this document or the basis upon which any such projections or opinions have been based and no responsibility or liability is accepted in relation to the use of or reliance on any information, projections or opinions whatsoever contained in this document. Investors must make their own assessment of the relevance, accuracy and adequacy of the information and opinions contained in this document and make such independent investigations as they may consider necessary or appropriate for the purpose of such assessment. All such information, projections and opinions are subject to change without notice.

HASE and its affiliates may trade for their own account in, may have underwritten, or may have a position in, all or any of the securities or investments mentioned in this document. Brokerage or fees may be earned by HASE or its affiliates in respect of any business transacted by them in all or any of the securities or investments referred to in this document.

The investments mentioned in this document may not be suitable for all investors. Investors must make investment decisions based on their own investment objectives, financial position and particular needs and consult their own professional advisers where necessary. This document is not intended to provide professional advice and should not be relied upon in that regard.

No consideration has been given to the particular investment objectives, financial situation or particular needs of any recipient. Investment involves risk. Investors should note that value of investments can go down as well as up and past performance is not necessarily indicative of future performance. This document does not purport to identify all the risks that may be involved in the securities or investments referred to in this document.