Forecasting Hong Kong house prices – Does capital flight signal a price drop?

November 2019

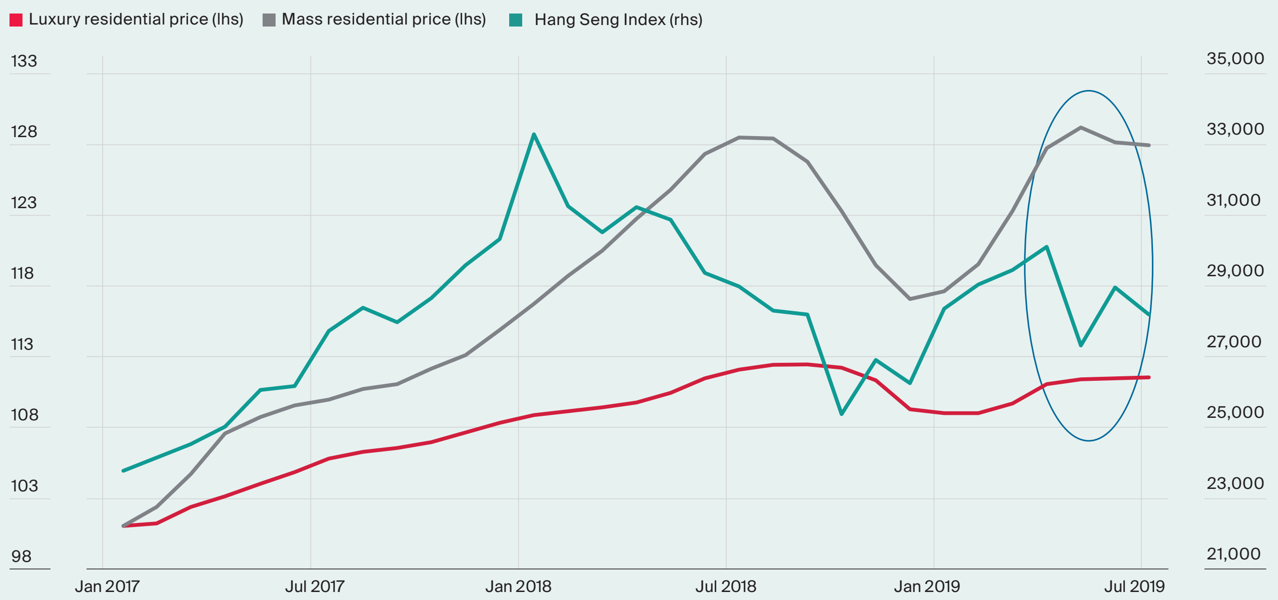
Does our theory still hold?

Back in January, long before all the market turbulence began, we published a report assessing the impact of various market factors on Hong Kong housing prices (https://bit.ly/2CVtzML). Our conclusion then was that Hong Kong's particular economic structure means that while factors like interest rates and housing supply do impact housing prices in Hong Kong, the GDP, typified by the Hang Seng Index (HSI), is a much more powerful indicator for measuring and forecasting the housing price trend. We also found that historically, it leads mass market house prices by 3 to 6 months. Since then, our hypothesis has been shown to be largely in line with the market, and even some non-residential research houses jumped on the bandwagon some months later.

However, the drastically evolving social and economic events have given rise to questions about how well our theory responds to market shocks. Chart 1 is a zoomed-in version of our original chart, which shows the close relationship between housing prices and the HSI. The chart shows the steep drop in the HSI since May. Meanwhile, the residential home price curves, especially for the mass market, have also been pulled downwards (circled in the chart).

Chart 1: A closer look at housing prices vs. the HSI

Index (Jan 2017 = 100)



Sources: Hong Kong Exchanges and Clearing Limited, Knight Frank Research

Two things can be deduced from this finding. First, it shows that our original conclusion about the relationship between the HSI and housing prices remains sound. The immediate impact of the HSI in the second half of the year on mass residential prices (about 10%) was relatively mild, as we found there is normally a 3 to 6 month lag. This leads to the conclusion that the mass housing price correction in the second half of the year should be around 5%, although an unexpected shock to the HSI could cause prices to drop as much as 10% towards the end of the year or in Q1 2020.

Second, luxury market prices are as inelastic as we hypothesised. This is consistant with historical trends, as the economy has little impact on the decision-making process of high net worth individuals. Some recent housing transactions on the Peak seem to illustrate this case. The general lack of supply of luxury units also smoothes out the curve.

What about interbank liquidity?

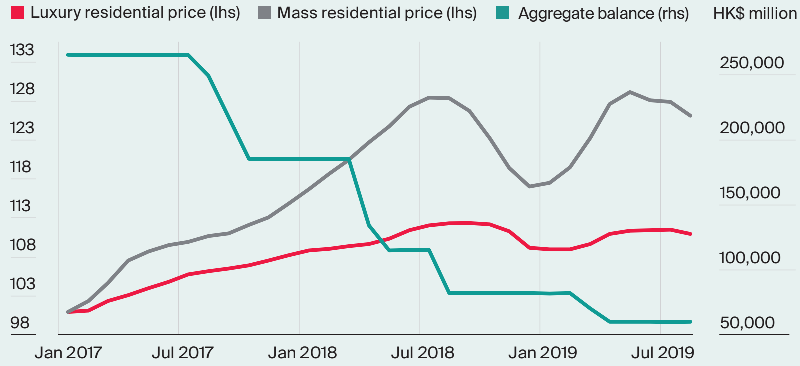
One of the variables examined in our original report was the level of aggregate balance, which is a proxy for interbank liquidity. This variable is one of two indicators that have seen significant movement recently, as the social unrest has sparked concern about liquidity movement. As shown in Chart 2, a zoomed-in version of a similar chart in our original report, the strong USD exchange rate and subsequent HKMA action to defend the HKD resulted in a drop in the aggregate balance in March to a post-financial crisis low of around HK$54 billion.

But the drop in aggregate balance does not seem to have any correlation with residential prices. This is still in line with the findings in our original report.

In fact, although the current aggregate balance is lower than level in the past few years, it is still much higher than the level before the Global Financial Crisis (about HK$10 billion). Given the ample interbank liquidity, the outflow of capital is relatively insignificant, and in any case, it does not have any direct bearing on housing prices.

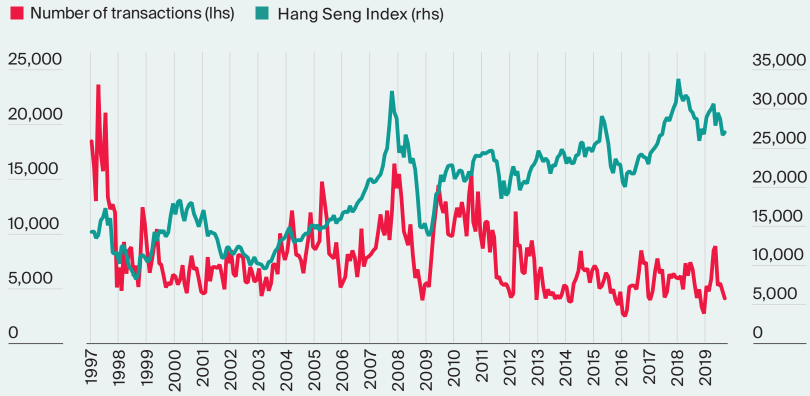
Chart 2: A closer look at housing prices vs. liquidity level (aggregate balance)

Index (Jan 2017 = 100)



Sources: HKMA, Knight Frank Research

Chart 3: Number of residential transactions vs. the Hang Seng Index



Sources: Land Registry, Hong Kong Exchanges and Clearing Limited, Knight Frank Research

We also examined residential transaction volume, as it is one of the housing variables most affected by the social unrest. Remember, we established in our original report that the HSI is a good proxy for the Hong Kong economy. Therefore, we wanted to see how the economic environment impacts housing sales. As Chart 3 shows, the HSI has no direct impact on the transaction volume, in contrast to prices.

Conclusions

After running the exercises again, we can conclude the following:

Our theory that the HSI leads mass residential prices in Hong Kong by 3 to 6 months still holds. This means that all eyes are on the health of the Hong Kong economy now. Only the social, policy and economic factors that will have a direct bearing on the economy can sway housing prices.

Although aggregate balance – a reflection of liquidity in the banking system – dropped in recent months, it did not have any visible impact on residential prices. This is also in line with our earlier findings.

Even though the movement of HSI is a reflection of GDP growth, it does not lead mass residential transaction volume as it leads prices. Market sentiment has a larger impact on volume than economic fundamentals do.

Although various policy measures are useful at the technical level, according to our theory, improved economic fundamentals are still the key to higher housing prices.

We like questions, if you've got one about our research, or would like some property advice, we would love to hear from you.

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