RESIDENTIAL
RESEARCH

Knight Frank

ASIA-PACIFIC RESIDENTIAL REVIEW

November 2013

SPECIAL ANALYSIS

The tapering of QE3 and its possible impact on the region's residential property markets

INTRODUCTION

HOW WILL ASIAN RESIDENTIAL PROPERTY MARKETS RESPOND TO TIGHTER MONETARY CONDITIONS?

Five years on from the collapse of Lehman Brothers, the Asia-Pacific residential markets have been through quite a roller coaster ride. While house prices in many markets corrected in the 2008/09 period, the accommodative monetary policy that we have seen in much of the west, China and now in Japan has meant that interest rates in many countries have been low for an unprecedented length of time.

This accommodative monetary policy has meant that house prices in a number of Asian markets have continued to head upwards despite policy maker's best efforts to cool the markets down (see Special Analysis: Cooling Measures in Asia-Pacific).

Low interest rates, which given inflation, actually mean you are losing money on your bank deposits in a real sense, has tempted many to invest further into residential property markets. Volatile equity markets and global economic uncertainty have further encouraged this trend.

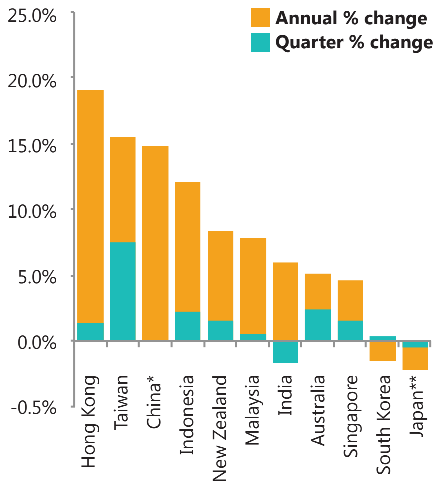
With talk now of a tapering of the monetary stimulus in the US, we have already seen what impact this could have, with bond yields rising, and capital flight from a number of emerging Asian equity and bond markets.

Although the US has yet to start reigning in the stimulus, which is not now likely until the end of the year or early next, the exact impact on Asian residential property is the source of some debate.

Following a brief review of the residential markets in the region (see page 3), this edition of the Asia-Pacific Residential Review considers the possible impact of a tightening of monetary conditions on the various markets across the region (see page 4).

While we demonstrate that interest rates are not as closely related to price performance as one would expect, there is no doubt that countries with currency pegs to the US dollar will be impacted – with volumes of new purchases likely to be hit and a corresponding pricing adjustment. Ultimately however, other factors such as economic performance are likely to be more important to the health of the region's residential markets than interest rates alone.

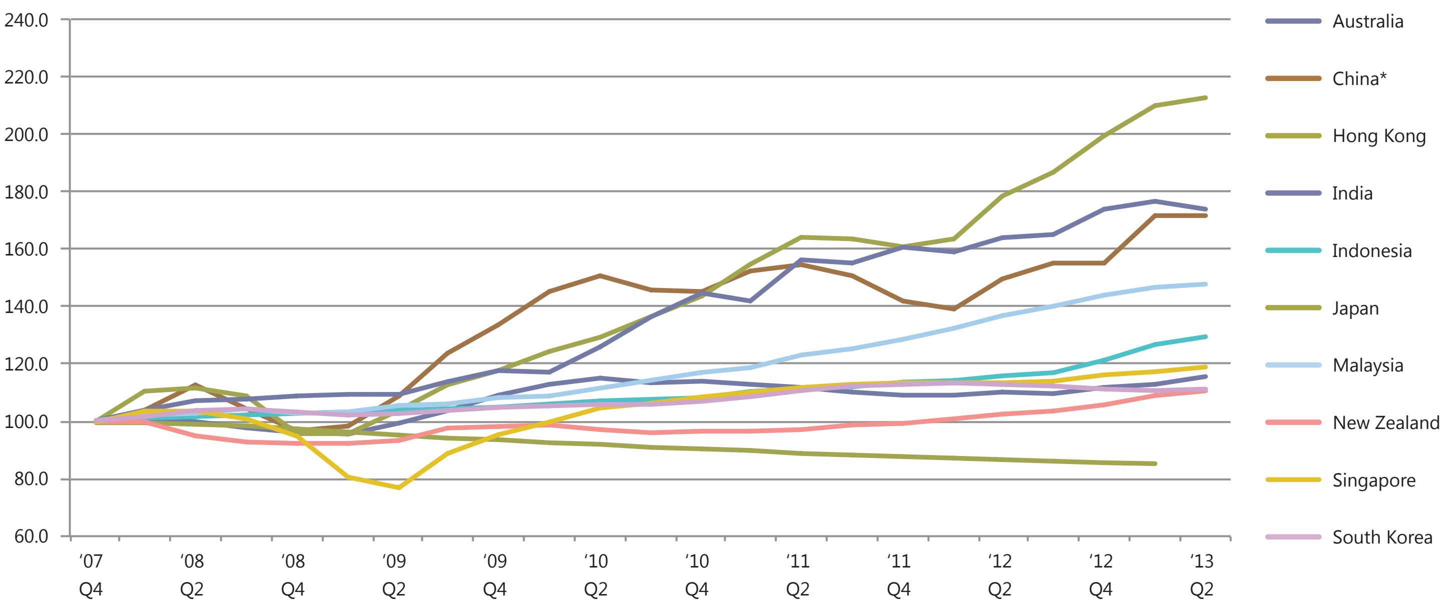
Figure 1
Global House Price Index Q2 2013



Source: Knight Frank Research
* Beijing and Shanghai
** Q1 2013 Data

Nicholas Holt
Asia Pacific Head of Research

Figure 2
Global House Price Index (Q4 2007 = 100)



Source: Knight Frank Research
* Beijing and Shanghai

REGIONAL SNAPSHOT...

In **Australia**, the sale of the first-release of Barangaroo, a flagship harbour-side project in Sydney's CBD sold out within hours, with a number of units being sold to Asian investors. The relative safe haven status for foreign capital and lower Australian dollar has encouraged an increase in interest from offshore buyers with Melbourne and Sydney continuing to attract the largest number of foreign purchasers, particularly from China, Malaysia and Singapore.

In **China**, the implementation of the "Five New Measures", which aimed to cool the residential market continues to vary significantly across the country. Prices have continued to increase across most regions, although volumes came off in a number of cities. Knight Frank's composite price index of Beijing and Shanghai remained stable over Q2 2013.

Market sentiment continued to weaken in **Hong Kong**, as the numerous rounds of cooling measures and the first hand sales ordinance, effective from the 29th April, saw price growth suppressed. Developers have reacted by redefining their strategies and postponing project launches.

India saw its average house prices turn negative for the first time in five quarters, dropping 1.7% in Q2 2013, as the deteriorating economic situation started to have an impact on the city's residential markets. Only four of 26 cities tracked by NHB saw positive price growth.

Effective from 30th September, the loan-to-value ratio for the purchase of a second property was reduced to 60% in **Indonesia** and to 50% for purchases beyond the second property. The move by the central bank follows a similar intervention last year as policy makers try to control a booming market in Jakarta. Prime condominium prices increased by 10.8% over H1 2013.

The **Japanese** market continues to see polarised performance in its residential market, with centrally located condominiums and apartments outperforming landed property and single family dwellings. The weakening of the currency has stimulated further interest from foreign buyers, with Taiwanese and Singaporean buyers heading the list.

The Bank Negara **Malaysia**'s (BNM) three policies introduced in July included reducing the maximum tenure of house loans to 35 years. The federal government followed these measures in October by doubling capital gains tax to 30 per cent for real estate sold within three years and doubling the minimum purchase price for foreign property buyers to one million ringgit. Nationwide house prices have increased by 44.2% since Q4 2008.

Long mooted measures were eventually introduced by The Reserve Bank of **New Zealand** at the end of September, with banks subject to restrictions on high loan-to-value ratio (LVR) housing mortgage loans from 1 October. The country remained one of the most robust performers in the region, with growth of 1.5% over the second quarter of 2013, with Auckland and Christchurch seeing the most significant price increases.

In **Singapore**: the total debt servicing ratio (TDSR) of 60%, introduced at the end of June saw sales activity slow in August and September. Volumes and pricing in the Core Central Region (CCR) and Rest of Central Region (RCR) have been more impacted due to the higher price quantums. Despite this slowdown, a number of new launches saw fairly healthy sales rates in the past month.

Thailand, Southeast Asia's second largest economy, slipped into a technical recession as GDP contracted for two consecutive quarters for the first time since the global financial crisis. The condominium market, especially in Bangkok however has not been adversely affected, as strong domestic and foreign demand continue to push prices higher.

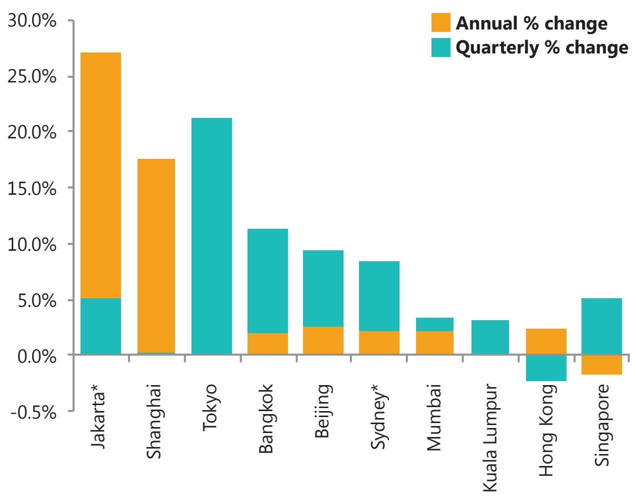
PRIME MARKET PERFORMANCE IN KEY ASIA-PACIFIC CITIES

The prime residential markets have undoubtedly been impacted by the various cooling measures that we have seen implemented across Asia Pacific. The outstanding performer however continues to be Jakarta, which has seen prices rise by 27.2% year-on-year. Otherwise, centrally located condominiums in Tokyo, most notably in Minato and Chiyoda wards have continued to outperform on a regional level.

Hong Kong and Singapore have been the markets most impacted by the multiple waves of cooling measures, with liquidity and pricing coming under most pressure.

More broadly speaking, Asia and "developing" Asia in particular, is very much the growth engine of the world economy, where we are seeing wealth growth and concentrations increase significantly. With more HNWI being created every year, this is fuelling longer term interest in prime residential property, which, when coupled with tight supply is likely to ensure that whether as an investment or for lifestyle, performance is likely to remain solid.

Figure 3
Prime Global Cities Index Q2 2013



Source: Knight Frank Research

SPECIAL ANALYSIS

THE END OF CHEAP MONEY?

The US Dollar and its importance to the region

Although the rise of China is ensuring that the US's two decades of sole world economic hegemony will slowly come to an end, the country still has huge influence. One of the key reasons for this is down to owning the world's reserve currency, the US dollar.

The importance of the greenback outside of US borders is not just through foreign reserves that sit in central banks around the world, but also by what could be termed a dollarization of a large number of countries including Cambodia and East Timor. Elsewhere in the region, the dollar has been used as a peg for a number of currencies to various extents (see box below). Although not explicitly pegged to the USD, a number of countries are pegged to a non-disclosed basket of currencies – often weighted by amount traded by value. With the dollar being the most traded currency by far, it is safe to assume that the US's currency has significant influence on these baskets, notably in Singapore and Malaysia.

The unconventional policies used by the US Federal Reserve over the past four years which were aimed at ensuring that the "great recession" did not turn into a "great depression" have involved huge bond buying programs, to ensure interest rates are low and liquidity remains in the economy.

The impact of these policies has been exported through various transmission methods to a number of Asian economies, firstly through rock bottom interest rates in those countries with pegs to the US dollar (see figure 4), and through capital inflows into emerging Asia's equity and debt markets, as investors search for returns not available in the low yielding west.

Famously termed "tapering", the slowing of the $85 billion monthly bond buying programme, will lead to an increase in US interest rates and bring an end to this unprecedented period of loose liquidity. We have already seen that talk of a tapering led to significant capital outflows from emerging Asia, as India, Indonesia, Thailand and Malaysia's capital accounts and domestic currencies come under pressure. But how are the region's residential markets likely to be impacted as this cheap money comes to an end?

How important are interest rates to house prices?

Intuitively, interest rates and house prices should be closely related. All things remaining equal, we could expect a negative relationship between these two variables, as a rise in interest rates increases the costs of buying a home, but also adds more incentive to savers to leave their money in the bank.

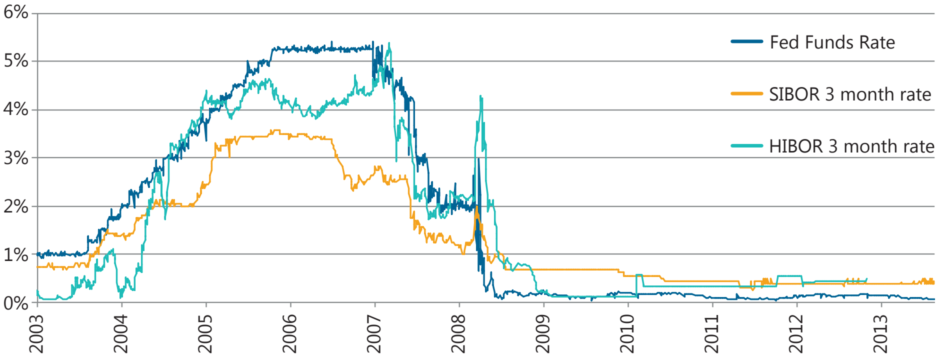
So how does this relationship hold up to scrutiny? Surprisingly, not very well. If we look at interest rates and house price indices for Hong Kong, Singapore and Australia since 1987 (see figure 5 opposite), we can see that the relationships are in fact inconsistent, with correlations showing a weak or moderate negative relationship.

Therefore while we know that interest rates are not the be all and end all for housing markets, our analysis needs to account for the historically exceptional period since 2009, that has seen ultra-loose liquidity policies in key economies around the world.

Given these circumstances, an exit from these unprecedented times, or more appropriately economies "weaning themselves off medication" will undoubtedly have some impact. This probably needs to be thought about in two ways. Firstly the impact on existing mortgage holders, and secondly, potential new buyers of property. On the first count, it is useful to examine just how indebted households are, to assess if a rise in interest rates could produce a chain reaction and more worrying results.

Figure 4
US, Singapore and Hong Kong Interest Rates

Correlation Fed Funds / SIBOR = 0.97 Correlation Fed Funds / HIBOR = 0.94



Source: Board of Governers of the Federal Reserve System, MAS, HKMA, Knight Frank Research

THE US DOLLAR'S INFLUENCE ON ASIAN MARKETS

Hong Kong Dollar (HKD) Pegged at around HKD7.80 to the USD. The Macau pataca (MOP) is pegged at MOP1.032 to the HKD.

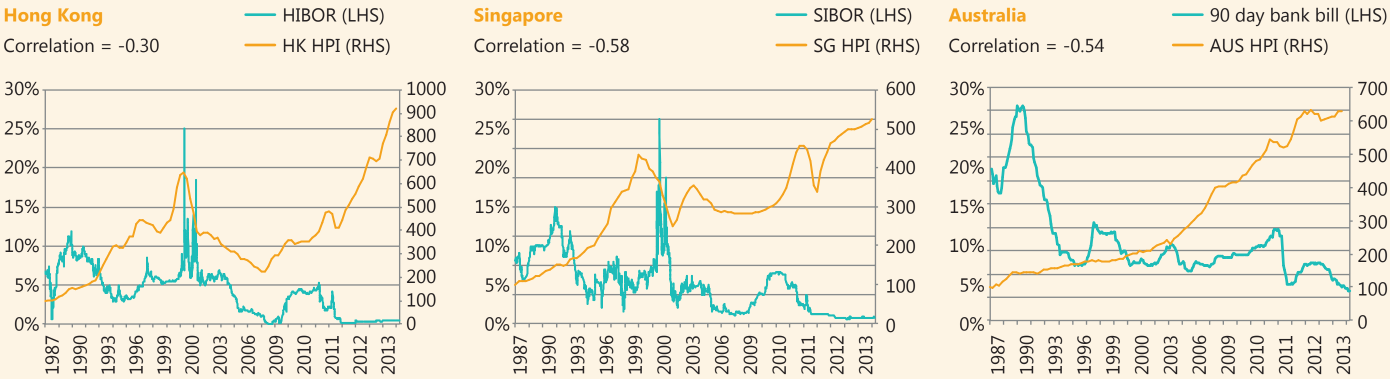
Singapore Dollar (SGD) Pegged to a basket of trade-weighted international currencies of which the US makes up a significant weight. The Brunei dollar (BND) is pegged at parity to the SGD.

Chinese Renminbi (RMB) De-pegged from the USD in 2005, now a "managed float" against a basket of trade-weighted international currencies of which the US makes up a significant weight.

Indian Rupee (INR) Officially a market-determined exchange rate, however, the RBI trades actively in the USD/INR currency market to impact effective exchange rates. Thus effectively a "managed float" with respect to the US dollar.

Malaysian Ringgit (MYR) According to Bank Negara, Malaysia allows the ringgit to operate in a managed float against several major currencies, with the USD making up a significant weight.

Figure 5
Interest Rates vs. House Price Indices



Source: HKMA, MAS, RBA, Knight Frank Research

HOUSEHOLD DEBT LEVELS ON THE INCREASE BUT ANALYSIS MUST BE NUANCED

Looking at household debt across Asia Pacific (see figure 6), we note immediately that levels are rising at quite a fast pace, with debt as a percentage of GDP in a number of countries rivalling those seen in the west. This rise, encouraged by the rising availability of credit and the unusually low interest rates has raised concerns in a number of markets.

Indeed the policy makers who have introduced property cooling measures in Singapore and Malaysia have highlighted the increase in debt levels as one of the main motivators to intervene in the housing markets. Most notably, The Singapore Monetary Authority intervened strongly in June, with a ruling that the total debt servicing ratio (TDSR) for any property buyer should not exceed 60% of their income. Further lending restrictions in Malaysia were also recently introduced as household debt increased by 12% over the year, bringing it to one of the highest levels in the region.

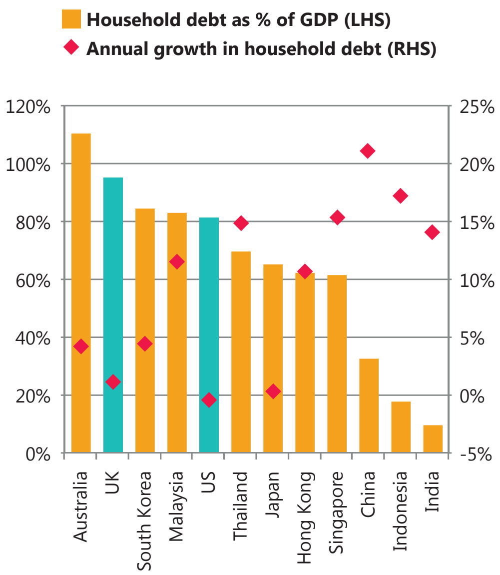
Elsewhere, absolute household debt in China, India and Indonesia remains at relatively low levels, although growth rates are some of the highest in the region. These regional powerhouses are continuing to expand and modernise and should have some way to grow in terms of debt.

It is important however, that a regional analysis of debt is carefully nuanced and viewed in light of other factors. High debt levels are not inherently problematic - high debt levels are problematic when incomes don't exist to service those debts. This is why the debt problems in the Eurozone are viewed as so serious, as the lack of growth in these countries will impair the possibilities to settle these debts.

With economic and income growth still robust and proving resilient in Asia Pacific, there is not a significant threat of decreasing real incomes, with only a severe economic turndown in the most highly indebted countries a risk.

The fear of a hard landing in China, something that had been singled out as such a potential trigger, seems to have receded. China is undoubtedly slowing down as it rebalances its economy – but a hard landing, as was once feared looks remote.

Figure 6
Household debt as at Q1 2013



Source: BIS, IMF, Bank Negara Malaysia, Knight Frank Research

So in general, although the rising household debt levels are understandably a concern, given that banks in Asia are much less leveraged than their western counterparts were prior to the 2008 credit crisis, and much of emerging Asia still has low absolute household debt levels, the the systemic risk looks low.

More incentive to leave cash in the bank, but uncertain times still makes property an attractive option

An increase in interest rates will shift incentives, the attraction of leaving cash in the bank will increase, potentially taking some demand for property from those who were leveraging low interest rates for property purchases.

There is no doubt therefore that sales volumes will be impacted, with the clamor to put money into property that we have seen over the last few years mitigated.

But although this will have some impact on numbers of new purchases of property, given the uncertainty around the tapering of QE3, and the general fragile nature of the world economic recovery, hard prime assets that have the potential to produce yield will still be in demand.

Certainly, the impact of a tapering of QE3 in China will be much less significant than in markets like Singapore and Hong Kong. As while the renminbi is weighted against a basket of currencies, the tight control of the currency, including fixed deposit rates will ensure that many of the fundamental reasons why property has been the investment class of choice will remain unchanged, including the large number of purely cash buyers.

CONCLUSION

MIXED IMPACT ACROSS THE REGION, BUT MUCH ULTIMATELY RESTS ON ECONOMIC PERFORMANCE

"Another interesting element to add to the mix is the impact to date of the cooling measures that we have seen in many markets... A reversal of many of these temporary policies could be a very real possibility."

The inevitable tapering of the extraordinary monetary stimulus measures in the US will lead to an increase in interest rates in a number of markets in Asia, with those with dollar or basket based pegs being most directly impacted.

This increase in interest rates will undoubtedly have some impact on residential markets that benefited from the cheap credit over the last few years. With inflation biting into savings, volatile stock markets and a lack of alternative investment options, residential property has really been seen as an attractive investment over the period.

What are the results likely to be? Singapore and Hong Kong are likely to see sales volumes further compromised as new purchasers see mortgage rates rise, and the attraction of property recedes slightly. Pricing however is more difficult to predict: as shown, house prices are not influenced by interest rates only, but more by fundamentals. Other factors (like economic performance) have a bigger impact on house prices than changes in interest rates. If the fragile global economic recovery continues, hard, income yielding assets such as property will continue to do well, on the other hand if the global recovery gains pace, property will again benefit from growth.

In emerging Asia (except China), although less impacted directly by rising interest rates in the US, further capital outflows could put pressure on domestic residential property prices. Again domestic economic performance will be the key set of indicators to monitor. China meanwhile is a separate market altogether, with the lack of market-set interest rates mitigating the impact of rising US interest rates, along with the amount of pure equity buyers.

When looking at the debt situation in many Asian countries, a perfect storm scenario of rising interest rates and a severe economic slowdown could potentially bring about a serious debt problem, although the risk of this scenario currently looks fairly remote. Although the emerging market powerhouses of China, India and Indonesia are seeing household debt increase at a rapid pace, they are still at levels well below those seen in the west.

Another interesting element to add to the mix is the impact to date of the cooling measures that we have seen in many markets. These measures have not only slowed price growth but also provide policy makers with the opportunity to try and re-inflate demand if market corrections prove too much. A reversal of many of these temporary policies could be a very real possibility.

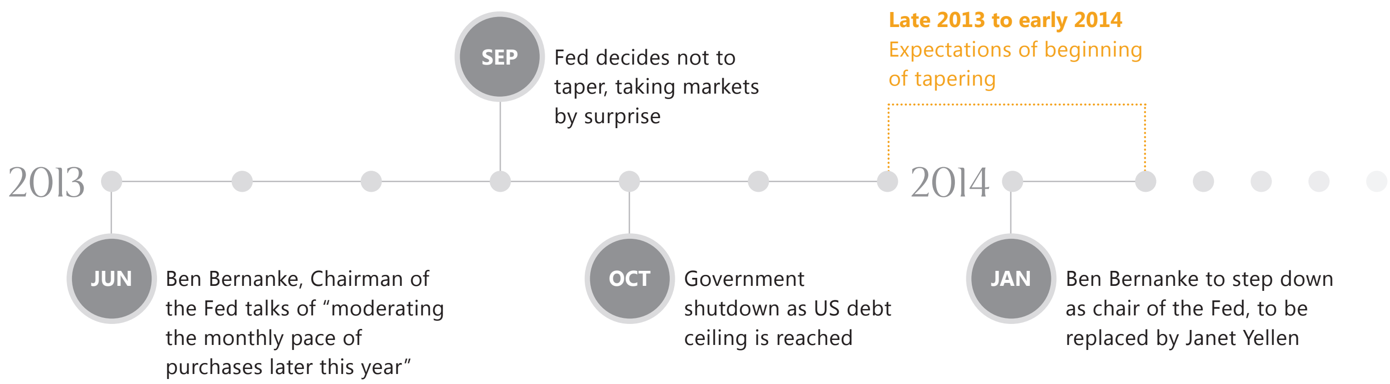
Stepping into the unknown...

One of the difficulties when analysing what is happening in the global economy and trying to predict impacts on various asset classes is that we have very little historical experience to draw on. This is because the monetary stimulus measures that we have witnessed in the US, China, Europe and now Japan have never been seen before on this scale.

Ultimately, while the tapering of QE3 will have an impact, the solid underlying fundamentals in a region that is still outgrowing the other regions of the world provide us with a degree of optimism going forward.

APPENDIX

Figure 7
Tapering Timeline



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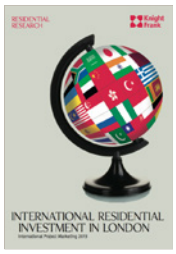

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