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Despite softer demand, prices stayed firm

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The number of transactions in the primary and secondary market declined 26.7% and 32.1%, respectively, on a QOQ basis. Overall home prices increased 0.8% from June to August, slower than the 4.7% QOQ increase in Q2. Despite the lower number of transactions in Q3, we remain positive about the market for at least the next twelve months in view of persistently low interest rates and sustainable end-user demand.

Forecast at a glance

Supply

12,436 units in the first eight months of 2017, an increase of 30.5% compared to the same period last year, or 73% of the whole year's volume according to an estimation by the government. We expect the whole year amount to reach 15,000-17,000, while the amount should stay at the similar level in the coming few years

Rent

Rental growth should stay positive for affordable luxury housing, while ultra-luxury units and houses should continue to soften. We expect overall luxury residential rent to increase at a CAGR of 1.0% from 2017 to 2021

Price

Increasing interest rates are unlikely to affect home prices until the end of 2018, when we expect real interest rates to turn positive for the first time since the Global Financial crisis of 2008-09

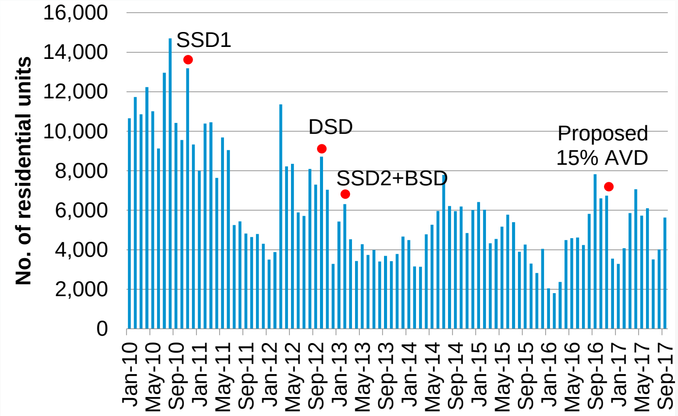
Market stayed resilient despite fewer transactions

As of August 2017, Hong Kong's residential prices have risen for 17 consecutive months. However, the number of transactions in the primary market has declined 26.7% QOQ to 4,577 units, while the secondary market has declined 32.1% QOQ to 8,581 units.

The lower transaction volume was caused by fewer new launches as well as seasonal factors, but the units launched in the Kai Tak Area, Yuen Long, Tsuen Wan and Tseung Kwan O were mostly oversubscribed and sold quickly.

Purchasing power was still strong among buyers, but some buyers put their purchasing decisions on hold as they expected that the new Policy Address would provide them with more affordable options for future acquisitions. On the other hand, the increasing wealth effect created by the rising Hong Kong stock market will have persuaded many buyers to make residential purchases. The HSI stock index now stands at 28,693, a nine-year high and up by 58% from its recent low point of February 2016.

Residential Sales and Purchase Agreements



Source: The Land Registry

The government sold four residential sites in Q3 for a total consideration of HKD4.9 billion (USD627 million). As particularly aggressive Chinese developers were absent from the tenders, the accommodation value for the three sites awarded to local developers was within market expectations. The fourth residential development site, in Lantau, was sold to the Chinese developer

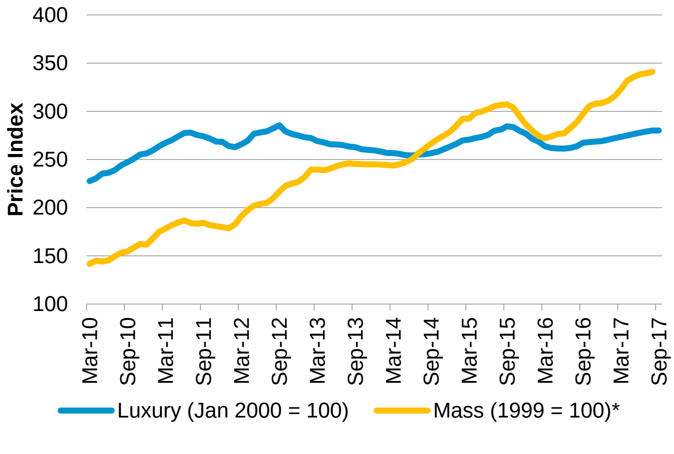
Country Garden for HKD210 million (USD27 million), achieving a price of HKD19,667 (USD2,528) per sq ft and beating market expectations by 36%. So far this year, 96% of Hong Kong residential sites have been sold to Chinese developers in terms of land value.

Record high prices continue to rise

Prices for residential properties in Hong Kong have increased for 17 consecutive months, as of August 2017. Despite a slower growth than the 4.7% QOQ increase in Q2, the market stayed resilient with overall home prices increasing by 0.8% over July and August. The mass market increased by a similar amount, 0.8% over Q3 as a whole, slower than the 4.8% QOQ increase in Q2, as a consequence of lower transactions in the market.

Given high stamp duty, sales are still restrained in the luxury districts on Hong Kong Island amid a high occupancy. The overall luxury residential price increased 1.7% QOQ, with demand for quality units on Hong Kong Island stronger than supply in the secondary market. The Peak remains popular for ultra-luxury unit purchases, with Mount Nicholson, the new luxury complex having recorded at least three transactions over the quarter for an average price of HKD67,000-80,120 (USD8,612-10,298) per sq ft.

Hong Kong Residential Price Index



Source: Colliers; Rating and Valuation Department
*refers to the units smaller than 1,076 sq ft

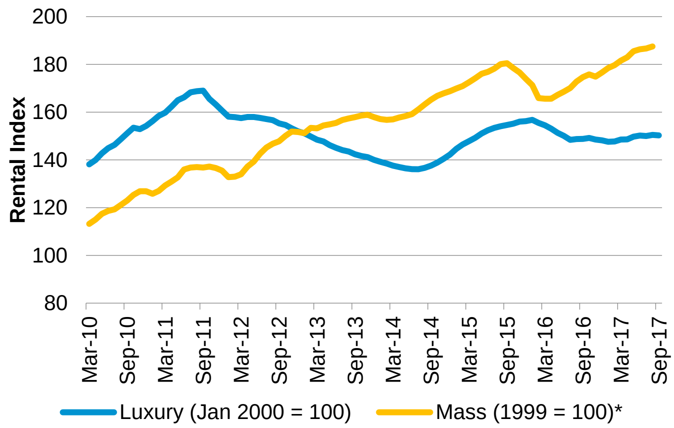
An active mid-tier market

Leasing demand for luxury residential units softened compared to Q2 for seasonal reasons. The overall luxury residential rent remained unchanged compared to Q2, supported by high occupancy in luxury districts on Hong Kong Island and increasing demand from PRC companies. The demand for ultra-luxury units and townhouses, where monthly rental for units exceeds HKD150,000 (USD19,280) remained subdued, with expatriates remaining cost-conscious and demanding more affordable housing. Given limited housing budgets, non-traditional districts outside the Island where properties adjoin international schools and transport connection, such as in Sai Kung, Lantau Island and Kowloon Tong, have been gaining popularity. The Peak, the top luxury district, softened and witnessed a rental decline of 0.4% QOQ.

The mid-segment of the luxury units in Mid-levels and Southside remained very popular. Landlords were not required to be more open to negotiations amid limited stock, with quality units being rented out quickly. As units with a monthly rent of HKD30,000-80,000 (USD3,856-10,283) are becoming the most popular, Happy Valley, which is accommodating more affordable luxury units, has witnessed the strongest rental growth, up 2.3% QOQ. The strong competition in traditional luxury districts has benefitted other areas such as the Western districts, which have strong new supply of small luxury units.

The shifting leasing demand to the middle segment of the luxury market fuelled by increasing rents is driving landlords to subdivide large units into smaller ones in order to raise monthly rents. Despite some developers having considered promoting the "co-living" concept in their properties, feasibility is still uncertain, given that fire safety requirements remain a major concern for subdivided units.

Hong Kong Residential Rental Index



Source: Colliers; Rating and Valuation Department
*refers to units smaller than 1,076 sq ft

Government initiatives to support purchases

Facing stiff competition from mainland Chinese developers in public land tenders, local developers have expedited the premium negotiation process with the government for converting their agricultural land banks into new residential developments. Moreover, local developers' strong interest in residential sites becomes apparent when taking a look at a recent redevelopment site in Mong Kok, which attracted a record number of 41 expressions of interest with local developers accounting for most of the submissions. We expect the trend to continue as we believe that restrictions on overseas real estate investments by Chinese authorities will not prevent mainland developers from purchasing Hong Kong residential sites, as many of them have sufficient offshore capital to pay for their overseas investments.

The Policy Address did not suggest lowering any of the cooling measures, including the 15% stamp duty and the lower loan-to-value ratio for non-first time home buyers. This should support the confidence of local end-users who believe that the market is less risky compared to 1997 despite the high price-to-income ratio. Meanwhile, the average capital ratio of banks in Hong Kong stood at 18.7% in June, according the HKMA. This was higher than global standards, suggesting the banking system had little exposure to credit risks.

Mrs Carrie Lam mentioned in her Policy Address that she will launch the Starter Homes scheme - a pilot scheme to sell private homes at a discounted price to eligible first-time local home buyers. We believe that the Starter Homes scheme will not have a major impact on the private housing market, as we anticipate the scheme's implementation to be slow due to a shortage of suitable and available land. However, these initiatives indicate that the government does not expect any drastic decline of property prices and so believes that homes will not become much more affordable in the short term as supply shortage remains.

While new supply remains the solution for the fast-growing prices, private residential completions reached 12,436 units in the first eight months of 2017, a 30.5% increase compared to the same period last year, or 73% of the whole year's volume according to the estimation by the government. To ensure adequate long-term housing supply, Mrs. Carrie Lam has formed a government task force on increasing land supply. It focuses on the feasibility of 12 proposed plans including the reclamation of reservoirs, the relocation of container terminals and the development of country parks.

Market unlikely to turn before real interest rates turn positive at about end-2018

Hong Kong has enjoyed negative real (i.e. inflation-adjusted) interest rates almost ever since the end of the Global Financial Crisis of 2008-2009. This is because Hong Kong interest rates are effectively tied to US rates by the territory's US dollar peg, and the US Federal Reserve has held US interest rates at very low levels for many years since 2008, Hong Kong residential; property prices have risen by about 330%.

The Federal Reserve has now started the process of unwinding its huge financial stimulus programme and of pushing up US interest rates. However, recent economic data from the US have been mixed, with inflation persistently low. Consequently, most observers expect that the Federal Reserve will only raise interest rates gradually over the next several months.

If this outlook is correct, then interest rates in Hong Kong should also only rise gradually. Consequently, we believe that real interest rates will only turn positive again at about the end of 2018. Until monetary conditions start to tighten, we expect residential prices in Hong Kong to remain very well supported.

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