WORLD MONEY ANALYST

A MAULDIN ECONOMICS PUBLICATION

December 2014

REPRINTED WITH PERMISSION

Global Property Market: Hong Kong

An Opportunity in Hong Kong Property

By Jayant Bhandari

Over the last several decades, Hong Kong, as well as Singapore, has been among the freest economies in the world, with minimal regulations and a very high degree of property rights. They rank as the top two jurisdictions for ease of doing business, according to the World Bank.

Ironically, these two islands of tranquility have matured and developed while surrounded by an extremely turbulent ocean of cultural and political repression. China, although it has increasingly relaxed its control over the last three decades, remains a centrally planned economy under authoritarian control. Repression has very deep roots in India, although this is not given much weight in the media because the country's political structure follows the Western, secular religion of democracy.

Even South Korea, Japan, and Taiwan have strong centralist tendencies, where the rights of the individual—and hence his property rights—can be easily compromised, with social acceptance achieved under the guise of the "larger social good." A Confucius-grounded cultural heritage in these countries indoctrinates the citizens to respect authority, and to compromise the self by having it dissolve into the larger collective.

Myanmar has only recently started to emerge from its military dictatorship and faces an unknown future. Yet, its form of governance takes its shape from a poison rooted in deep social fragmentation. Vietnam and Cambodia have recently been improving economically, but remain haunted by past episodes of genocidal madness. Indonesia, one of the largest countries in the region, also struggles with an elevated level of corruption.

All these countries are growing economically. Nevertheless, fear of a return to past social and political policies means that part of each country's wealth is fleeing to offshore locations in search of safety and asset diversification.

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Compromise Yield for Asset Protection

Hong Kong not only offers strong property rights, it continues to follow a policy of budgetary surplus and fiscal discipline, and enjoys a growing cache of foreign exchange reserves. Singapore and Hong Kong have both benefited from pro-business policies that facilitate the easy flow of trade in an extremely regulated region.

In the realm of banking and financial services, a long history of good conduct is required for a jurisdiction to establish credibility and maintain the confidence of investors. Switzerland is a prime example of this dynamic, and Hong Kong has done everything right to earn its reputation as a sound financial center.

It is a mystery why some investors in India and China will accept very low yields on parts of their wealth. In particular, investment property in both countries often have rental yields much lower than what banks offer on short- or long-term deposits. A likely explanation is that Indian and Chinese investors have developed a huge mistrust of their governments. In contrast, with a property investment, even if it were to lose half its value, the investor retains ownership of a physical asset. The psychology of being able to touch what they own is very appealing.

When Indian or Chinese or other regional investors are able to move money out of their home countries—which is not easy—and into Hong Kong or elsewhere, they are psychologically prepared to receive even lower yields in exchange for higher financial security. Ironically, this mindset has resulted in a virtuous cycle, given continually rising wealth over the last several decades throughout Asia, and increased capital inflows from the West where wealth-generators have steadily lost trust in their home governments.

Hong Kong has reaped big rewards from the migration of foreign capital into its various markets.

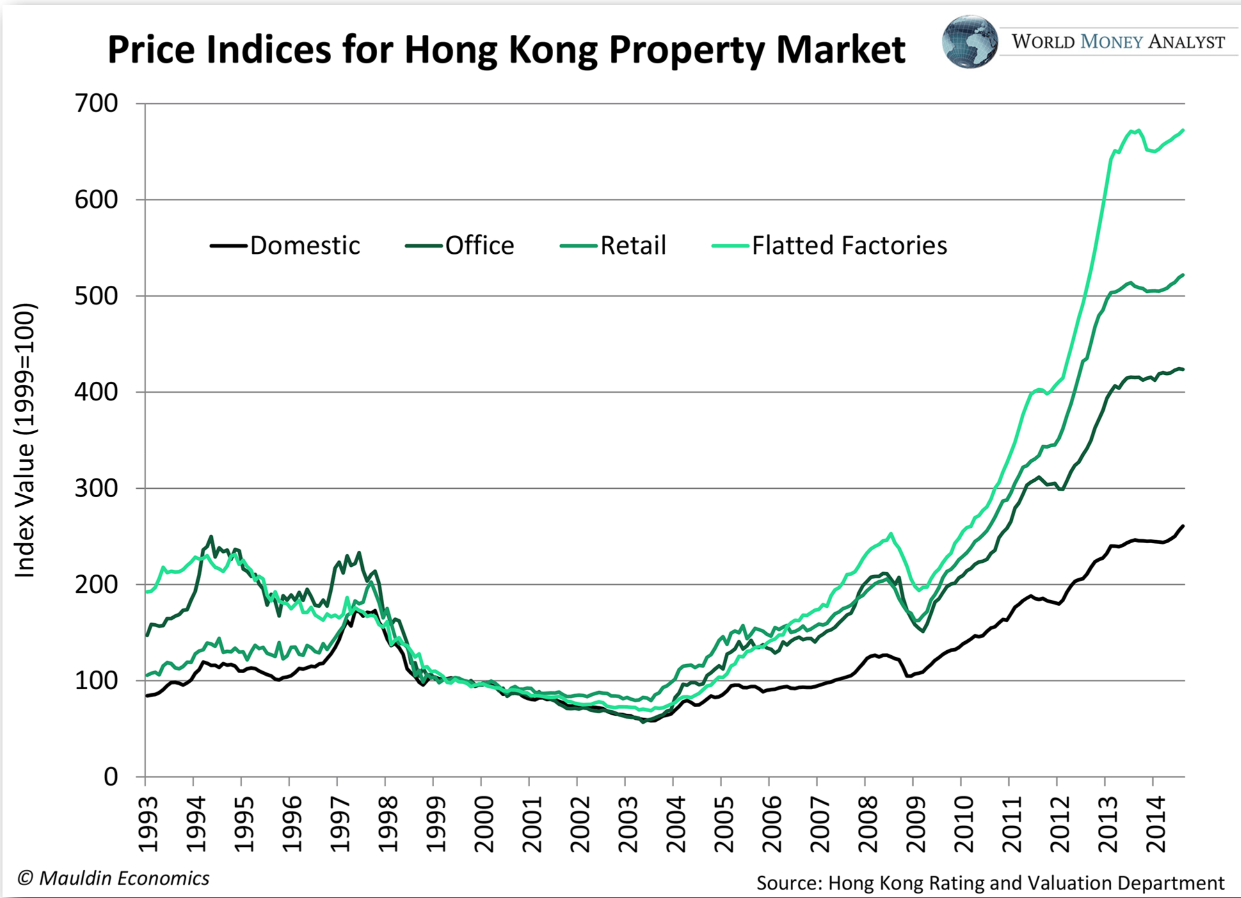
Hong Kong: A Preferred Destination

Hong Kong is a small place, slightly smaller in area than New York City. Only about 25% of the land has been developed due to hilly and mountainous terrain and set-asides for nature reserves and parks. This limited supply of buildable land has had to confront a continual infusion of demand from foreign capital in search of safety and yield.

The outcome is straight out of Economics 101: a persistent escalation in property prices, a development that cannot be explained through a simplistic use of value-investing tools. To assist the locals and their suffering from high property prices, and to curtail the economic drag from high rental rates, the Hong Kong government has taken measures to curb speculative investments by non-residents and foreigners. However, this has achieved only mild success, as property prices stagnated in 2013, but have since started to rise again.

In general, Hong Kong public policy should have resulted in consumer price deflation. Alas, the Hong Kong dollar is pegged to the US dollar. This means that Hong Kong residents must subsidize the US treasury and Hong Kong monetary authority, resulting in inflation and its consequent exaggerated effect on property prices.

Hong Kong is among the world's most expensive property markets, and the local residents don't necessarily believe that prices must always rise, as was the case during the heady days of the Spanish property market bubble. Indeed, the 1997-2003 correction in the Hong Kong property market—when prices fell by a third, shown in the chart below—remains fresh in the minds of local investors and speculators.



A rise in US interest rates could also have a negative impact on Hong Kong property. The question is whether the market is set for a fall, and if now is the time to buy.

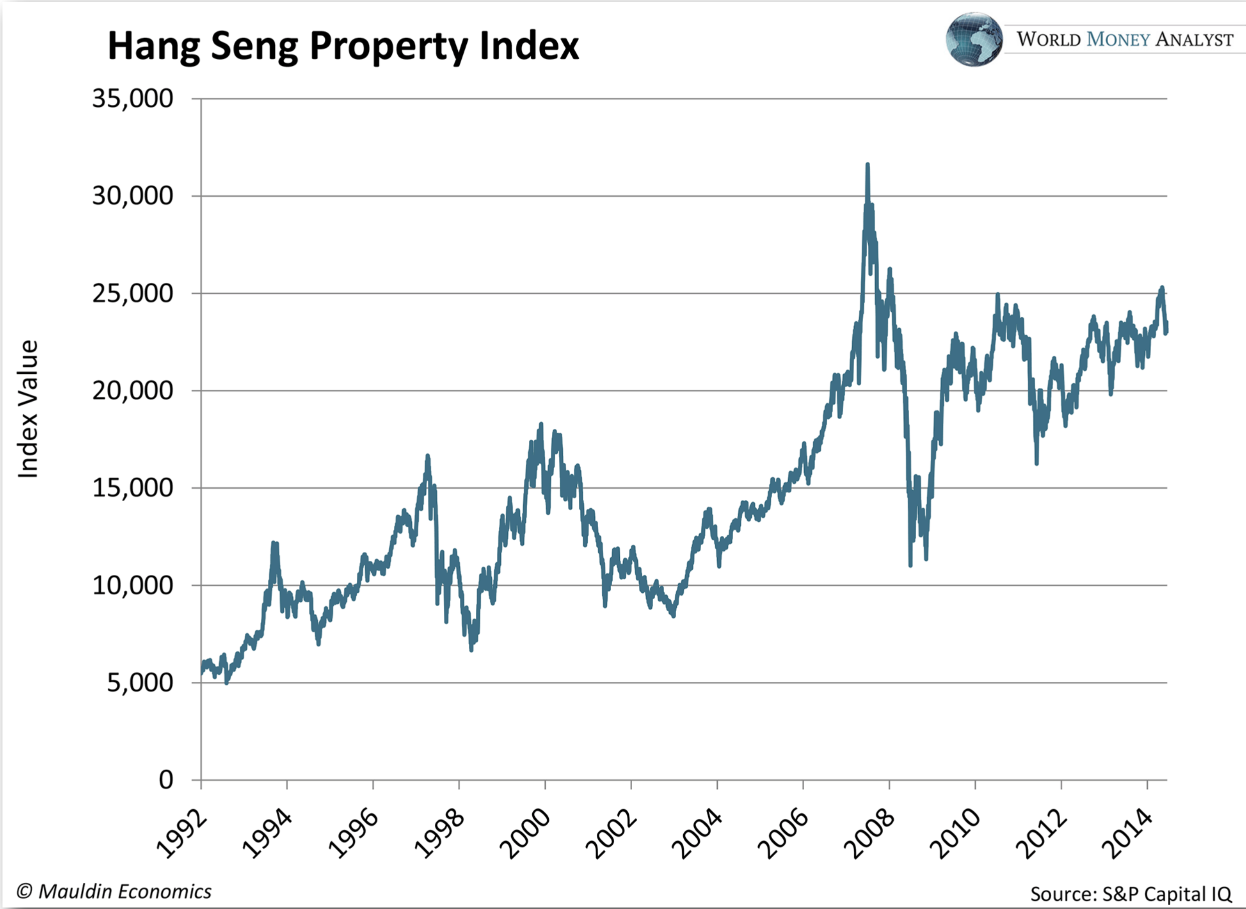
High property prices have a tendency to incite higher rents. Elevated rental rates, in turn, can act as a drag on the economy by eating away at what would have been profits, or by creating uneconomical conditions that fail to attract or retain qualified employees. Evaluated as a multiple of rents or personal income, Hong Kong property prices are high by historical measures, although they are comparable to those in Canada and New Zealand. While apparent high prices—as I explain above—does not mean that property prices must fall, it does not leave a margin of safety for a value-investor for whom protection of capital is of prime importance.

Fearing a collapse in the property market, the Hang Seng index of property companies (shown in the chart below) has been volatile, and hugely lagged the actual increase in property prices. The former is affected by sentiment, whereas the latter reflects market reality. The consequence is that today, the mark-to-market values of many of Hong Kong's property and development companies is 50% to 200% above their market capitalization.

Gloomy forecasts for Hong Kong property is for a likely fall in prices of about 30%. But this is what makes Hong Kong property companies so exciting: They currently trade at a discount far below even the worst-case scenario for property prices. This is a value-investor's utopia.

Moreover, it is indeed possible for the Hong Kong economy to support higher rental yields, and hence, continue to positively affect property prices. Further, the Hong Kong dollar is 30% undervalued on a Purchasing Power Parity basis (and roughly 50% undervalued according to the Economist's Big Mac index), an anomaly for a rich nation. This suggests that the Hong Kong economy can support a commensurate increase in costs, including rents, and still remain competitive in the international arena.

One might conclude that this competitiveness comes at the cost of herding groups of poor people into small, dingy apartments due to the lack of minimum wage support and welfare programs, the reason you see people in their later years doing janitorial work. Irrespective of the ethical aspect of how the economy functions—and I find it ethical—the economic policies and a lack of regulatory burdens do provide massive relative cost advantages to Hong Kong that should enable it to bear higher costs elsewhere, including higher rents.



Will the Hong Kong property market create a less-competitive local economy that negatively impacts property prices? Or will Chinese, Indian, and other international investors in search of asset protection and diversification continue to buy Hong Kong property and support prices?

I am betting on the latter for the simple reason that investors in many parts of the world, and increasingly in the West, are seeking asset protection, even if they must pay an "insurance" premium in terms of accepting a possible correction in property prices. But for a margin of safety, I would own Hong Kong property by investing in listed property companies that trade at a huge discount to their NAV, a discount that exceeds even the gloomiest expectations for property prices.

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WORLD MONEY ANALYST, A MAULDIN ECONOMICS PUBLICATION

Publisher: Mauldin Economics
Managing Editor: Kevin Brekke

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