

# **Hong Kong Faces Sub-prime Contagion**

**By Daniel Po-min Chan**

The US sub-prime crisis emerged after US housing prices dropped moderately in 2006-07. During the US property boom of the past decade, loan incentives—such as "teaser" interest rates that later jump significantly in conjunction with rising housing prices—encouraged borrowers to assume difficult mortgages in the belief they would be able to refinance easily on more favorable terms. However, once housing prices reversed the up-trend in 2006 in some parts of the US, refinancing became increasingly difficult. Thus defaults and foreclosure on mortgages, particularly sub-prime lending, started to rise.

Thanks to innovations in securitization, many mortgage lenders had passed the rights to mortgage payments and related credit/default risks to third-party investors via mortgage-backed securities (MBS) and collateralized debt obligations (CDO). After many years of this mortgage debt securitization, related derivatives have become widely used in the markets and, because of its leveraging, their impact has greatly increased. Consequently, the bursting of the US property bubble not only made US mortgage companies its victims, but also global investment banks, hedge funds and retirement funds, among others. Because they hold large amounts of those securities, they face significant losses.

The past year has seen the collapse of several banks, including America's Bear Stearns and Britain's Northern Rock. With the US housing market still sluggish, banks are re-evaluating risks, particularly those linked to housing markets. Amidst concerns of more fallout, in particular credit crunch, from the sub-prime mortgage crisis, recent data suggests that leading economies, including Britain and Japan, are flirting with recession.

Regarding fears over credit crunch, the US Treasury and the Federal Housing Finance Agency (FHFA) on September 7 announced that The FHFA has put Fannie Mae and Freddie Mac into conservatorship until December 31, 2009, effectively taking operational control. The FHFA suspended dividend payments on common and preferred equity to preserve capital. The FHFA also announced the support for the guarantee fee business (without limits) and will enable a limited growth of the

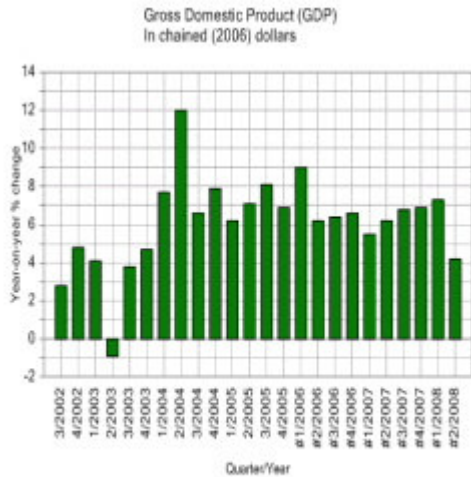
portfolio and if necessary, providing the liquidity of the two. Democratic and Republican presidential candidates expressed support for the plan.

The plan can not reverse the fall in US property prices as the mortgage bad debts will continue to rise. However, it will help support the mortgage lending business and thus avoid free fall of the property market. Fed funds futures market was little changed, and the market expected the Fed will hold rates steady. More importantly, Washington's plan to save the market temporarily removed the global financial "time bomb", giving a respite to the global credit market. In fact, credit spreads of Fannie Mae and Freddie Mac narrowed by 40 basis points on September 8 to 38-45 basis points.

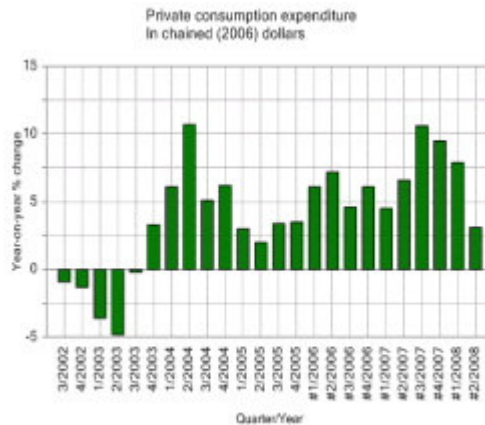
### **The Hong Kong Economy Remains Resilient but a Slowdown is Inevitable**

Given its strong economic integration with China, despite external challenges including volatility in the financial markets and continued high energy prices, the Hong Kong economy remained resilient with real gross domestic product expanding moderately by 6.4% in 2007 and by 5.8% year-on-year in the first half of 2008. Nevertheless, the second quarter GDP figure, which grew moderately by 4.2% following a strong 7.3% growth during 2008's first three months (see figure 1), suggests that the headwinds from slowing growth in the major industrial economies plus lingering financial market turbulence increasingly pose a drag on the local economy. A moderation in consumption (which accounts for over 60% of GDP) is also increasingly apparent; it slipped for the third consecutive quarter to 3.1% year-on year in 2008's second quarter from a 7.9% rate at the end of March. Consumption was also restrained by a volatile stock market, rising inflation and expectation of slower payroll growth. Consumers have cut back on big-ticket spending, with an evident drop in sales of durable goods, electronics, jewelry and valuable gifts.

### **Figures 1 and 2: Hong Kong Real GDP and Consumption Growth**



# Figures are subject to revision later on as more data become available. Figures are the latest data released on 15 August 2008.



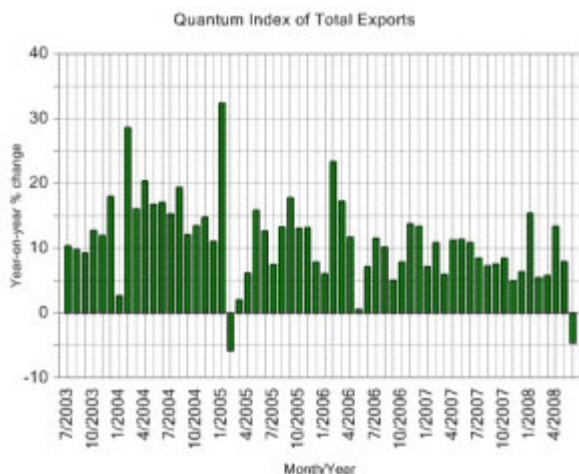
# Figures are subject to revision later on as more data become available. Figures are the latest data released on 15 August 2008.

Source: Census and Statistics Department, HKSAR Government

## The Economic Outlook is Uncertain

If the sub-prime housing mortgage crisis snowballs and results in a severe economic downturn in North America and Europe, weakening exports could be the biggest threat to Hong Kong's economic expansion. Export growth in this year's second quarter nearly halved growth in the preceding quarter as a global slowdown and a more expensive Chinese yuan curtailed demand for China-made goods shipped through Hong Kong. Exporters are eyeing the upcoming Thanksgiving retail sales, which is a barometer for the strength of the even more important Christmas season sales in the US.

### Figure 3: Export growth



Source: Census and Statistics Department, HKSAR Government

In the labor market, Hong Kong's unemployment rate unexpectedly fell in May-July to 3.2%, its lowest level in more than 10 years, indicating a still tight labor market despite sharply slowing economic growth. However, the unemployment figure is a lagging indicator. Employers have become more cautious about hiring, according to a survey published last month by the recruitment company Hudson Highland Group Inc. Of 746 company executives it surveyed, only 42% said they will increase hiring in the third quarter, down from 57% three months earlier.

Despite all this, there is reason to remain cautiously optimistic about Hong Kong's prospects for the rest of 2008. Domestic demand, which is less vulnerable to a global slowdown but dependent upon Chinese tourists and investment activities, remains a major impetus of growth and the mainland's strong economic performance looks set to continue. Against this backdrop, Hong Kong should achieve full-year GDP expansion close to 4.4% in 2008 and 4.2% in 2009, though both are lower than 2007's 6.4% rate.

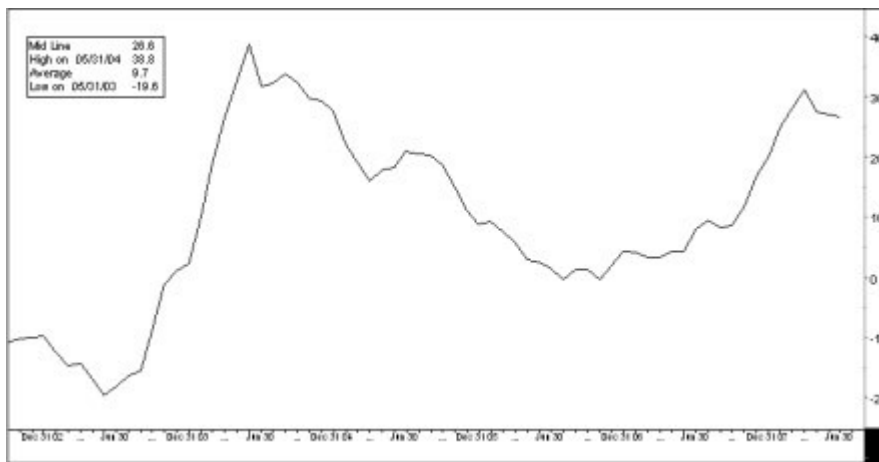
### **Hong Kong's Property Market Finally Feels the Heat**

Despite the resilient local economic outlook, it is a different story in the property and stock markets. The outbreak of the sub-prime crisis increased the possibility of having negative real interest rates. We therefore witnessed a vibrant Hong Kong property market in the year's first quarter. Due to the global credit crunch, the US Federal Reserve has taken various measures, including cutting Fed funds rate by 3.25%, to help

strained money markets. And because the Hong Kong currency is pegged to the US dollar, the Hong Kong Monetary Authority tracks the Fed's interest rate adjustments. Local banks have also lowered rates down to a prevailing effective mortgage rate of only 3%. With inflation running about 5%, the local real estate market has seen negative lending interest rates since late last year, creating a favorable environment for real estate investment.

However, residential property prices rose so dramatically in recent times, with the overall private domestic index up 30%, that these can be difficult to sustain. Meanwhile, the local lending rate is set to bottom out despite a further US rate cut in April. In addition, individual local banks even announced plans to raise their effective mortgage rates by scaling back loan incentives, including a discount on mortgage rates and the reduction of cash rebates from perhaps 1.0% to a maximum of 0.5% on new mortgage loans.

**Figure 4: HK Residential Property Price YOY growth**



Source: Bloomberg

With the dashing of hopes for further rate cuts in Hong Kong, coupled with the global economic slowdown and the prolonged sub-prime mortgage crisis, a mild market correction has occurred in recent months. In July, the sales and purchase agreements for residential units totaled 7,433, down 27% month-on-month and 19% year-on-year. Their total value was HK\$25 billion, down 50% from June 2008 and 13% from July 2007. In coming months, the pace of capital value growth risks is on the

downside, due to growing risks of a global economic contraction and the expectation of a continuing cycle of tightening in 2009.

### **Stock Market at Low Tide**

In the stock market, the Hang Seng Index experienced high volatility during the year, declining by over 30% from last October's peak. Last year's rise had been propelled by the August, 2007 announcement from China's State Administration of Foreign Exchange that it would allow direct individual investments in Hong Kong securities. However, a delay in this scheme, poor performance in the A-share market (partly due to the launch of a series of macroeconomic control measures in mainland China) plus concerns over more credit losses, continues to weigh on market sentiment. More importantly, the recent release of several lower-than-expected corporate earnings, followed by analysts' downgrades of key stocks, has highlighted fears that firms in China have been hit by the cooling global demand. Any sudden contraction in global liquidity or a stampede to redeem funds could lead to liquidations by international investors, despite the relatively solid local economic fundamentals.

### **China as a Main Impetus**

Global credit markets are in trouble but there are few signs of a serious credit crunch in Asia, particularly on the Chinese mainland, thanks to the mainland's strong economic fundamentals and limited exposure to this particular variety of asset. Sub-prime-related losses may be material in dollar terms, but are not considered so when taken in relation to the total capital of most Chinese banks. On the economic front, China's annual GDP growth eased to 10.1% in the second quarter from 10.6% in the first three months, due to slowing exports, further macroeconomic tightening and the devastating Sichuan earthquake. However, growth in China remained in double digits, where it has been since 2003. As a result, a strong China economy definitely will help Hong Kong cushion the impact of the sub-prime crisis, at least when compared to other Asian economies.

.....

*Dr. Daniel Po-ming Chan is a senior investment strategist at DBS Bank (Hong Kong), where he analyzes the economies and investment environment of the greater China region.*

