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Asia Property

24 June, 2016

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Brexit highlights value of core Asian property

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In our view, the UK's unexpected vote to leave the EU has three chief implications for Asia Pacific property markets. Firstly, Brexit will probably lead to further downward pressure on already very low global bond yields, increasing the relative attraction of the 3-6% yields on core APAC investment property. Secondly, the vote should remind investors of the potential for shocks in developed as well as emerging countries, and hence mitigate political and economic concerns about the APAC region. Thirdly, the vote may mean that real interest rates stay low for longer than we have assumed up to now, to the near-term benefit of Hong Kong and other regional markets. These implications support the cautiously positive stance on core investment property that we advanced in our recent APAC Capital Markets report.

In our recent Asia Pacific Capital Markets report, "Brightest Light in the South", we made various arguments. The first was that investment (above all office) property in core Asia Pacific markets offered good value compared to other asset classes, given low or falling nominal interest rates in most countries except the US; benchmark global bond yields at record low levels, and generally uninspiring yields on Asian equity markets. In the near term, the UK's unexpected vote to leave the European Union is likely to lead to further downward pressure on global bond yields, which in many cases already stand at record lows. At the time of writing, the US ten-year bond yield has dropped to 1.47% – close to the 1.38% level of July 2012 which was the low point for the last ten years, while the corresponding yields in Germany and Japan are -0.11% and -0.19% respectively.

Against this background, the yields currently offered by the major Asia Pacific property investment markets look neutral to attractive. As shown in Figure 1 below, headline yields on major Asian office property markets currently range between 2.9% for Hong Kong and 5.7-6.0% for Melbourne and Sydney*. As Asia Pacific bond yields have also been falling, the spreads that Asia Pacific investment property offers over local bond yields have increased. The spreads now vary between 1.9% and 4.0%. The office property markets which now offer the greatest returns above the local benchmark bond are Australia and Japan. This may be a prima facie sign that domestic investors in these markets have the greatest potential to support their local property market by increasing fund allocations to real estate.

*4.0-4.8% in Sydney on an effective basis taking account of incentive payments, although this is a blunt and questionable calculation

As second major argument in our report was that surging capital outflows from Asian real estate and stagnating capital inflows over the past eight years principally reflect caution about Asia, not about Asian property. Global investors are mostly cautious about economic prospects in China, sceptical about reforms in Japan, and concerned about political and economic risks in Asian emerging economies except perhaps for India. However, in our view, the shock of the UK's vote should serve as a salutary reminder to international investors of the potential for negative political and economic surprises in developed western as well as emerging economies. In the wake of the UK's vote, Japan may well appear more stable than many western countries. Opinion towards China may well also improve, although south-east Asia will probably continue to be seen as a "risky" regon, at least for the time being.

Figure 1: summary of key Asia Pacific office property markets

City	Prime grade rent growth avg p.a. to 2019	Prime grade cap rate (current)	10 yr bond rate	Cap rate spread over bonds (percentage pts)
Sydney	3.8%	6.0%	2.00%	4.0%
Melbourne	4.0%	5.7%	2.00%	3.7%
Hong Kong	4.0%	2.9%	1.01%	1.9%
Singapore	4.5%	4.0%	1.90%	2.1%
Shanghai	4.8%	5.4%	2.88%	2.5%
Tokyo	-2.4%	3.7%	-0.19%	3.9%

Note. Singapore and Tokyo to end-2018. Source: Colliers International, Bloomberg

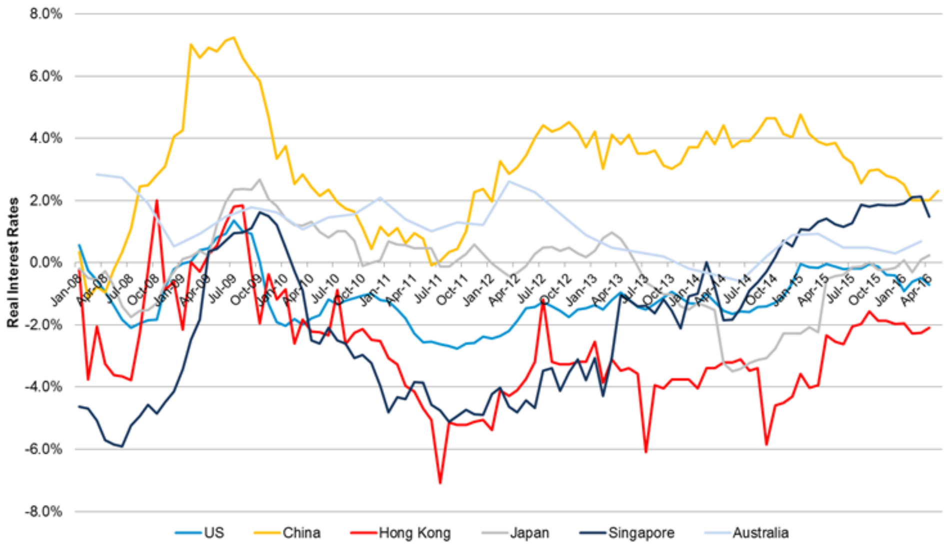
Our third main argument was that moves in real interest rates are the key swing factor that will drive Asia Pacific property markets in the near term. In this context, prospects for Asia Pacific investment property look brighter in the wake of the Brexit vote. It is only very rarely that the US Federal Reserve connects developments overseas to its decisions about US interest rate levels. However, only about ten days ago Janet Yellen hinted that Brexit might have been a factor in the Federal Reserve's decision not to increase US interest rates in mid-June. The fact of Brexit and attendant concern about increased global economic risk may delay increases in US interest rates, even if they seem certain to rise gradually over the next few years.

Any delay in US interest rate increases is good news for Hong Kong property markets, since it will prolong the period in which Hong Kong enjoys negative real interest rates. Hong Kong has enjoyed negative real interest rates since the end of the GFC in 2009; the effective real interest rate in Hong Kong is currently –2.1%. No other major Asian market has experienced negative real rates over all this period. The fact that money has been so cheap to borrow in Hong Kong for so long is, of course, one of the principal explanations for the surge of nearly 200% in Hong Kong mass residential property prices between end-2008 and their peak in 3Q 2015. In our major report, we assumed that real interest rates in Hong Kong would be approaching positive territory again by end-2015, with negative implications for capital values in the Hong Kong office property market and more obviously the residential market. While it is still too early to be sure, the point of return to positive real rates in Hong Kong may have been delayed by several months.

If the ramifications of Brexit help to hold down global interest rates more generally, other markets in the Asia Pacific region should benefit too. The core Asia Pacific market where nominal (i.e. non-inflation-adjusted) monetary conditions have eased most noticeably in recent years is probably Australia, thanks to progressive rounds of rate cuts by the Reserve Bank of Australia. We believe that the real interest rate in Australia has fluctuated between about zero and 0.9% over the past 18 months or so. Although this means that monetary conditions in Australia are perhaps slightly tighter than is generally appreciated, it seems clear that the central bank's steady and deep rate reductions have helped drive property markets in the country. Despite negative nominal interest rates, since inflation in Japan is is very close to zero, in real terms monetary conditions are actually less loose in Japan than in Hong Kong. In Singapore, meanwhile, we believe that real interest rates have been trending up since late 2014, partly due to deflation in the country.

We still see Australia as the most attractive market in the region, given high prime-grade office yields and strong interest from Chinese and other foreign investors. Despite rising supply, firm demand and a 5.4% yield should allow CBD capital values in Shanghai to rise in the near term.While near-term prospects for the Hong Kong office market are bright, given firm demand from Chinese groups for en-bloc purchases, the prime office property yield of 2.9% remains the lowest in the region. Singapore office property offers a yield of 4.0% and solid rental growth over the next few years. However, strong growth in supply is a challenge.

Figure 2: real interest rates in major APAC markets and the US (2009-2016)



Source: CEIC, US BEA, US Federal Reserve, MAS, RBA

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