

UBS Investment Research

Emerging Economic Focus

Emerging Markets

Hong Kong

How To Spot a Housing Bubble

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Remember, an experimentalist, in contrast to a theoretician, will be mistaken only once - and then they will no longer believe him.

— Lev Artsimovich

A silly question?

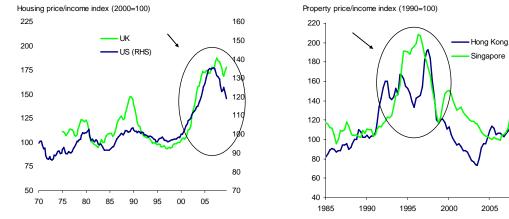
For today's Focus report, we begin with what appears to be a very silly question indeed: How do you spot a housing bubble in emerging markets?

Why is this silly? Well, because almost every investor knows what a housing bubble looks like: Prices go up ... a lot. And then they go down ... a lot. End of story.

Or is it? Needless to say, in many cases prices tell you everything you need to know. Take the recent bubbles in the US and UK as examples; looking at the behavior of home prices relative to incomes in Chart 1, it was easy to spot the sharp run-up in the ratio, both in absolute terms and relative to historical averages, beginning in 2001-02.

Chart 1: The US and UK bubbles

Chart 2: The HK and Singapore bubbles



Source: CEIC, Haver, UBS estimates. The chart shows nationwide residential prices divided by the average of per-capita GDP and household earnings.

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2005

The price bubble was pretty easy to spot in Hong Kong and Singapore in the 1990s as well (Chart 2) – and as we discussed in *The Next Emerging Bubble (EM Perspectives, 18 November 2009)*, housing prices ran up very visibly (and sharply) in many Central and Eastern European markets over the past five years.

But what about these cases?

But what about, say, the Asian crisis economies? As we show below, real estate lending and investment played a huge role in the run-up and subsequent bust in places like Thailand, Korea and Malaysia – but you would never know it by looking at the behavior of headline price-income ratios in Chart 3 below; according to official statistics, at least, residential prices were flat or falling relative to incomes for most of the 1990s.

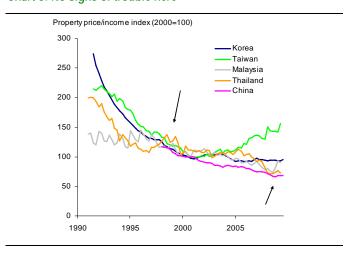


Chart 3: No signs of trouble here

Source: CEIC, Haver, UBS estimates. The chart shows nationwide residential prices divided by the average of per-capita GDP and household earnings.

Nor would you know it from looking at the broad data in economies like Indonesia or the Philippines, for the simple reason that there are no good broad time-series figures to be had (we note that this is the case in much of Latin America and Africa as well).

Nor, despite all the current hype about the state of housing markets in China today, would you get any sense of underlying pressures in the mainland by looking at prices (the pink line in Chart 3); over the past ten years China has actually seen the largest trend decline in headline property price/income ratios among all the Asian countries we tracked above.

Watch volumes and leverage - not prices

And this leads us to the key finding of this report, which is that in the EM world simply watching prices is not always a good indicator of pending trouble in property markets.

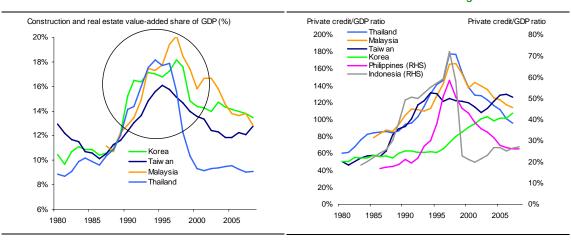
Are there better measures out there? In our view, yes: in addition to prices, investors should be looking at (i) volumes and (ii) leverage.

What do we mean? Well, if you take an indicator as simple as the share of GDP accounted for by construction and real estate activity, there were clear warning signals in all the above Asian cases. Relative volumes nearly

doubled between 1987 and 1997, then fall off sharply in the aftermath of the crisis – and have never come even close to regaining those peak levels since (Chart 4).

Chart 4: A better indicator - volumes

Chart 5: A better indicator - leverage



Source: CEIC, Haver, UBS estimates

Source: CEIC, Haver, World Bank, UBS estimates

The same is true when we look at readily-available data on credit to the private sector as a share of GDP (Chart 5); there was an extraordinary increase in economy-wide leverage ratios in nearly every case – including the Philippines and Indonesia but, interestingly, excluding Korea – followed by a sharp drop as the crisis unfolded.

And it's not just Asia; housing construction/transactions volumes and overall credit ratios were also consistent indicators of trouble in the US and UK as well as the Eastern European boom-bust countries. So here is a set of measures that seems to work for all the economies we surveyed.

The bottom line is that it may not always make sense to talk about housing *price* bubbles in emerging markets, at least not where headline data are concerned – but we have yet to see a problem case where *volume* and *credit* bubbles were not involved.

Back to Hong Kong and China

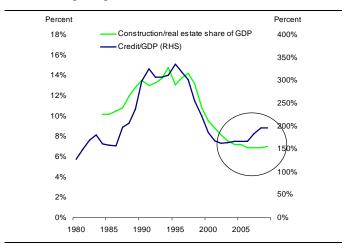
These points can help enormously in clarifying the debates surrounding the most common "bubble" candidates today, i.e., Hong Kong and China.

First, Hong Kong. To many observers it feels like we're "right back in the mid-1990s" ... but looking at the numbers it's clear that the economy is nowhere near as imbalanced as it was back then. Of course prices have been very buoyant over the past few years, and the market rebounded very quickly indeed from the 2008 global shocks, but as you can see from Chart 6 there has been no upturn whatsoever in construction or supply activity, nor has there been much local credit expansion. All of this stands in sharp contrast to the 1990-97 period, and the implication is that this time around prices have been supported primarily by fund inflows from abroad (a point that is very clear from UBS Asian regional economist **Duncan Wooldridge's** work on the economy).

So while global risk reversal could easily cause near-term retrenchment, there's really no sense in which Hong Kong would be facing a post-1997-style property market depression. And as Duncan has stressed, there is still plenty of room for potential further upside as the domestic credit cycle picks up.

¹ The lines for Thailand and Malaysia in Chart 4 include value added for financial intermediation as well as real estate services, as these are reported together in the available national accounts data.

Chart 6: Hong Kong indicators



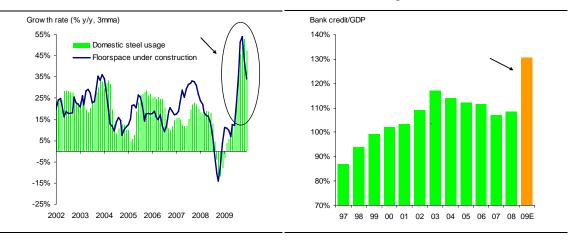
Source: CEIC, Haver, UBS estimates

Turning to China, the discussion becomes more interesting. We've looked at the mainland property market in depth in a number of previous reports so we won't go through all the details here, but the two key conclusions are as follows:

First, as UBS China economics head **Tao Wang** has continually emphasized, there is no real evidence of a structural bubble in Chinese housing. Prices have been relatively well-behaved, as we saw above. There has certainly been an upward trend in the physical volume of housing construction as a share of the economy over most the past decade, but not an unreasonable one given the magnitude of reforms that opened up private housing market in the late 1990s. And crucially, overall mainland leverage ratios barely rose between 2000-08, and actually fell from 2004 onwards.

Chart 7: China volumes

Chart 8: China leverage



Source: CEIC, Haver, UBS estimates

Source: CEIC, Haver, World Bank, UBS estimates

However, the problem comes when we look at the last 12 months. Housing prices have started to rise at a pace faster than incomes. Physical construction and sales volumes skyrocketed over the course of 2009, by much more than could be explained from a post-2008 "rebound" alone (Chart 7 above). And for the first time in many years the credit/GDP ratio jumped tremendously, to record heights (Chart 8).

In short, all of the warning flags that normally point to trouble ahead – to some extent prices, but especially volumes and leverage – have suddenly appeared.

Does this mean that China is now threatened with a pending structural collapse? Well, no; once again, using the historical experience from the Asian crisis countries in Charts 4 and 5 above or the more recent stories in the US, UK and Eastern Europe, the "normal" length of a bubble cycle with excessive leverage and overblown construction and real estate activity would be at least four to five years before things fell apart – i.e., by this metric it's still early days in China, and there is plenty of time for the authorities to step in and cool things down.

The bad news, though, as Tao also stresses, is that the process of tightening monetary policy almost inevitably means a sharp y/y slowdown in property and construction, given how inordinately fast the numbers have run in the second half of last year. And this means that a lot of "big China bears" – although very wrong on the structural call in our view – could appear very right for a few quarters as momentum drops off. So please keep a close eye on this space.

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