alpha commentary

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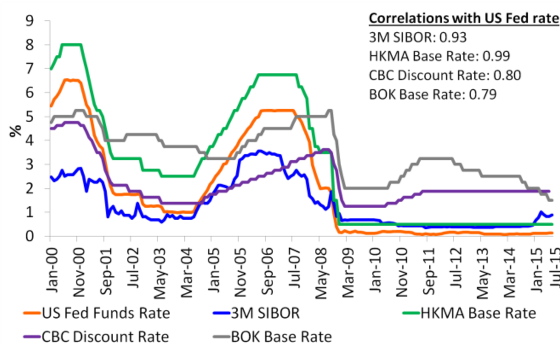
US Fed rate hike: Mixed impact on Asia

All eyes are on whether the US Federal Reserve will raise interest rate later this year or push back the rate hike till next year, given the modest growth of the US economy and the recent global equities sell-down. This commentary discusses the impact of the Fed rate hike on major Asian economies and property markets.

Impact on Asian short-term interest rates

Interest rates in Singapore and Hong Kong are likely to respond faster to a US Fed hike given their high correlation with the US Fed rate as both countries do not manage domestic interest rates (Figure 1).

Figure 1: US, Singapore, Hong Kong, Taiwan and Korea Interest Rates



Source: Bloomberg, MAS, HKMA, CBC, BOK, AIP Research

Domestic interest rates in Taiwan and Korea also have relatively high correlation with the US Fed rate, but their increase is likely to be later than in Singapore and Hong Kong as their governments would be inclined to keep rates low to support economic growth. Although they would benefit from a stronger US GDP growth which usually underpins a Fed rate hike, this will be muted by China's economic slowdown given that China has accounted for a proportionally larger share of Asian exports in the last few years.

A more volatile RMB, following the recent shift in China's exchange rate policy, could also impact the tourism sectors in Taiwan and Korea, which could provide further incentive for both countries to keep interest rates low and push their currencies weaker.

Interest rates in other Asian economies are also not likely to rise quickly when the US hikes rates. China and Japan are expected to maintain relatively loose monetary policies to boost growth while emerging markets such as Malaysia and Indonesia are likely to maintain rates to cushion against capital flight.

Impact on Asian exchange rates

Given that the Asian economies, except for Hong Kong and Singapore, manage their interest rates, they will likely face more currency volatility when the Fed hikes its rates, especially those with high foreign-currency denominated debt and dependent on foreign funding. This will be exacerbated by the change in RMB policy.

Indonesia and Malaysia are likely to be most vulnerable in Asia. Indonesia is a net debtor nation, holds the least foreign reserves in Asia relative to GDP and has the highest foreign-currency (FX) denominated external debt in Asia (85% of total external debt)[1] (Figure 2). In Malaysia, foreign holdings of government bonds make up 15.4% of GDP[2], the highest amongst Asian countries while falling foreign reserves and recent political problems further dampen investor confidence.

The looming Fed rate hike, coupled with other economic and political problems, have already seen the IDR and MYR depreciate about 24% and 35%[3] respectively against the USD since their previous highs in April and August 2014.

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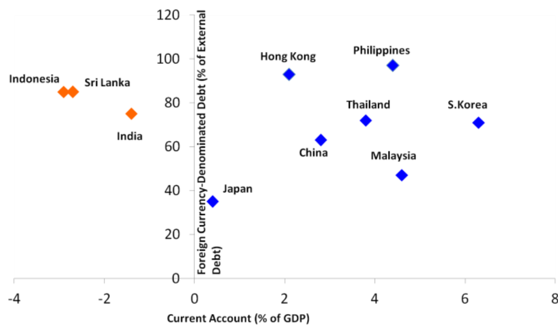
[1] Standard Chartered, Asia Leverage Update – Focus on external risks, 11 Jun 2015
[2] Morgan Stanley, A Comparison of the current cycle with 1997-1998, 24 Aug 2015
[3] As at 24 Aug 2015

Figure 2: Current Account vs Foreign-Currency Denominated Debt in Asia

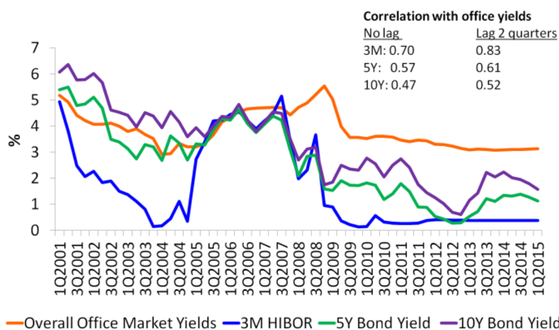


Source: Bloomberg, Standard Chartered Research, AIP Research. Data as at 4Q2014 except for China (1Q2015)
Note: Data on foreign-currency denominated debt not available for Singapore, Taiwan, Vietnam & Myanmar

Impact on office market yields

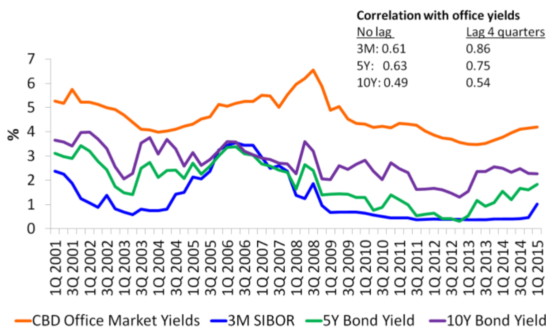
Intuitively, higher interest rates imply higher required returns and hence higher property yields. Our analysis of four key Asian office markets however shows that there is no universal 1:1 relationship between interest rates and office yields. The correlation is high in Hong Kong and Singapore but low in Seoul and Tokyo (Figures 3 and 4). During the boom years 2005-2007, office yields in Seoul and Tokyo fell despite rising interest rates and narrowing yield spreads.

Figure 3: Hong Kong office yields and interest rates



Source: JLL REIS, Bloomberg, HKMA, AIP Research

Figure 4: Singapore office yields and interest rates



Source: JLL REIS, Bloomberg, AIP Research

If the past relationship between office yields and interest rates hold in Hong Kong and Singapore, this implies that their office yields could move up in 2Q-4Q2016. Historically, office yields in Hong Kong reacted faster with a time lag of about 2 quarters while there is a longer lag of about 4 quarters in Singapore.

However, as the US Fed's quantitative easing (QE) programme is unprecedented, there is a possibility that office yields in Singapore and Hong Kong may react differently in the coming rate hike cycle. The abundant capital that continues to chase assets, underpinned by the monetary easing in Japan, EU and China, could keep yields compressed.

Even if office yields were to rise as a result of interest rate hikes, it does not necessarily imply that capital values will fall, as this could be due to expectations of future capital gains such as in the case of Singapore, which has strong long-term fundamentals; or rents rising faster than capital values. A study by CBRE[4] found that real estate values are driven more by the near-term expectations of rental growth (via demand derived from economic growth) than movements in short-term interest rates. In Hong Kong, further rental and capital value growth will be supported by the tight supply and healthy demand.

Impact on Singapore and Hong Kong residential markets

A Fed normalisation and the inevitable increase in domestic interest rates in Hong Kong and Singapore will increase mortgage financing costs. The Hong Kong Monetary Authority (HKMA) had estimated that an increase of 3.0%-points in mortgage rates will lead to an increase of about 30% in monthly mortgage payments[5], while the Monetary Authority of Singapore (MAS) had estimated that the percentage of over-leveraged households (those with monthly debt-servicing burden greater than 60%) could increase from 5-10% in 2013 to 10-15% should mortgage rates rise by 3.0%-points[6].

[4] CBRE, Fundamentals are first in driving global real estate yields, 16 Jul 2015
[5] HKMA, Half-Yearly Monetary & Financial Stability Report, Mar 2014
[6] MAS, Financial Stability Review, Dec 2013

However, the cooling measures implemented in the past few years to improve financial prudence, such as higher medium-term interest rate to stress-test mortgage repayments, lower LTV ratio and cap on debt servicing ratio, could help to temper the effects of an increase in interest rates in Hong Kong and Singapore, provided there is economic growth and employment. The pace and extent of rate hikes in the US is also likely to be slower than previous rate hike cycles. Residential prices in Singapore and Hong Kong had risen during previous periods of interest rate increases when supported by strong economic growth.

Thus we do not expect a plunge in prices in Hong Kong and Singapore as a result of an interest rate hike unless there is a prolonged period of economic contraction given the high correlation between prices and economic growth.

Implications for real estate investors

While an outflow of hot money is expected in the region when the US Fed hikes its rate, creating volatility in the stock and bond markets, we expect capital flows to be more stable in the real estate markets. According to JLL, based on transactions in 1H2015, 90% of real estate in Asia Pacific was bought by Asia Pacific investors: 80% by local buyers in their home countries and 10% by other Asia Pacific buyers. Therefore, capital flows to real estate are unlikely to reverse rapidly following a Fed rate hike as the capital is often invested in long-term projects with a 5- to 7-year time horizon.

The threat of an economic slowdown or recession will be of a bigger concern to investors than an increase in interest rates. According to CBRE's Global Investor Intentions Survey 2015, investors do not appear to be as concerned about rising interest rates as they were in 2014. Only about 5% of respondents selected US tapering and rising interest rates as the biggest threat to property markets, down from 24% in 2014's survey. This was helped by the accommodative monetary policies by other central banks.

Conclusion

The impact of a Fed rate hike is mixed for Asia. Domestic interest rates in most markets are not expected to rise immediately upon a Fed rate hike other than in Singapore and Hong Kong. Office capital values may not necessarily fall even if office yields were to rise. Other factors such as the abundant capital chasing assets and expectations of capital gains could keep office yields compressed. Investors are likely to be more concerned about economic growth than an expected increase in interest rates. Although the inevitable increase in interest rates in Singapore and Hong Kong would have some impact on mortgage financing, previous macro-prudential measures will provide some buffer.

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