portfolio construction forum

China's property bubble is set to burst!

Sam Churchill | Magellan Asset Management | 31 July 2015

A credit-fuelled property bubble enabled China to maintain its incredible run of growth through the global financial crisis (GFC). However, now China has to deal with a massive excess supply of property that is causing construction activity to contract along with a range of other linked sectors in the Chinese economy, as millions of homes lie vacant. China's property boom has created approximately three to four years of excess supply, comparable to recent property booms in the US, Spain and Ireland which all ended in deep recessions and financial crises. This is unlikely to be "just another property cycle" in China Recent stock market volatility demonstrates that asset price growth expectations can't be taken for granted in China, despite intervention and assurances from policymakers. The bursting of China's property bubble poses a major risk to both the country's stability and the global economy - and will have implications for asset prices around the world.

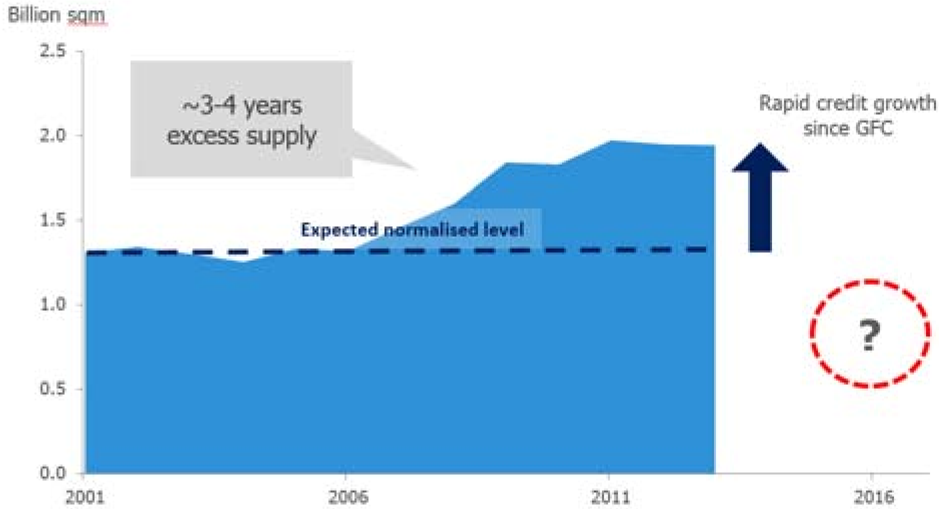
BACKGROUND TO CHINA'S PROPERTY BUBBLE

Following the privatisation of the housing market in the late 1990s, China has rapidly become a nation of property owners, with approximately 80% to 90% of households owning at least one property. At the same time, property development has become a major industry. In 2007, the country was constructing around 1.5 billion square metres of gross residential floor space per year (or approximately 15 million housing units) to support urbanisation, to replace old housing stock and to meet the investment needs of Chinese households. By 2013, despite a fall in the rate of urbanisation, the annual residential construction rate reached 2 billion square metres (Figure 1 over page)[1]. This equates to at least several million more units of housing being constructed each year than new households being formed. This excess construction activity has continued through 2014 and into early 2015.

During the Global Financial Crisis, property market restrictions were loosened considerably and credit growth was accelerated, driving up property prices and increasing speculative investment. New government subsidies for housing were introduced, while local governments borrowed from banks and sold land to property developers in order to fund infrastructure projects, further fuelling the property boom.

A serious geographic mismatch developed between housing supply and demand. Although the economies of scale and scope driving China's urbanisation generated strong housing demand in Tier 1 and Tier 2 cities, a disproportionate share of property development was concentrated in smaller cities. Subsequently, Tier 1 cities such as Beijing and Shanghai generally suffer housing shortages, while Tier 3 and Tier 4 cities hold most of the excess supply. The share of new property sales in Tier 3 and Tier 4 cities has increased substantially since the early 2000s.

Figure 1: Housing completions in China have exploded
National residential floor space completed



Sources: NBS, Magellan

The excess supply problem is compounded by a lack of affordable housing available for domestic migrant workers who account for the majority of new urban household formation. Almost 60% of migrant workers live in company dormitories or on work sites, while most of the remainder rent. Very few migrant workers own a home near their place of work. Part of the problem is the hukou system which precludes migrants from purchasing property outside their home region.

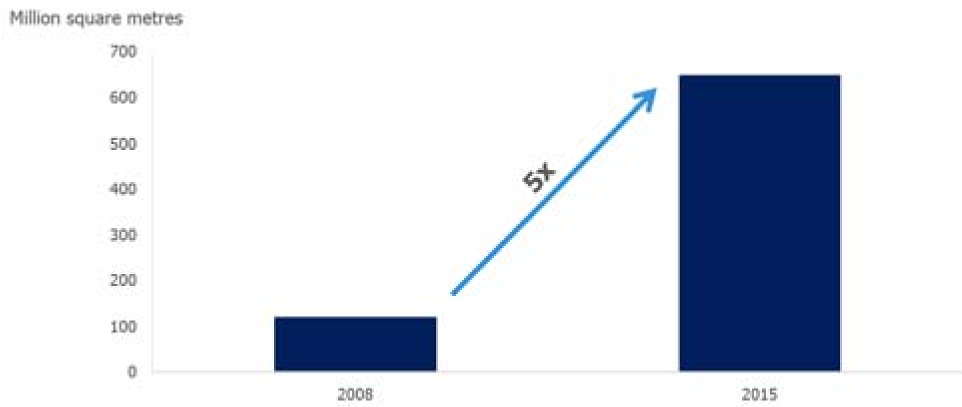
China's government sector has directly contributed to the property glut, having built an estimated 46 million low-cost, subsidised housing units from 2010 to 2015. In January 2015, China's minister for housing, urban and rural development announced that the government would stop building low-cost housing in Tier 3 and 4 cities, due to a severe oversupply problem, and would instead subsidise households to buy empty apartments.

China has been demolishing and replacing old housing stock at a rapid rate, and has a diminishing pool of old housing left to replace. Approximately 75% of China's urban housing stock was built after 1990, including approximately 40% built since 2000. The demolition rate in China is high, at around 4.5% of China's housing stock per annum, and increased almost 50% in the period from 2005 to 2010, which could be a sign of overinvestment[2]. Demolitions account for a material portion of annual housing construction in China.

While supply has been growing, slowing urbanisation and unfavourable demographics are putting downward pressure on property demand. In 2014, China's urban population increased by 18 million, the lowest rate of increase since the GFC, some three million fewer new urban residents than the average of the past five years[3]. China's working age population (aged 15 to 59) peaked in 2012 and is currently declining by several million people each year. The main property buying demographic, the population aged 25 to 49, is expected to peak in 2015 and decline thereafter. The number of workers who migrate from rural to urban areas in China is also declining. These factors are likely to exacerbate China's excess supply problem and increase the risk of a hard landing in the next few years.

Most of China's excess housing supply is vacant stock held by private investors, with the remainder on the books of real estate developers, many of whom are highly indebted. According to the China Household Finance Survey, 22% of urban housing is vacant while vacant floor space on developers' books increased by over five times since 2007 (Figure 2)[4].

Figure 2: Rapid inventory growth signals oversupply
Vacant unsold housing inventory on Chinese developers' books



Sources: NBS

THE MARKET IS RESPONDING TO THE EXCESS SUPPLY PROBLEM

The huge build-up of unoccupied properties held by investors and developers is currently driving a major contraction of construction activity. National house prices have fallen 5% in the past year and urban housing completions are down 15% so far in 2015.

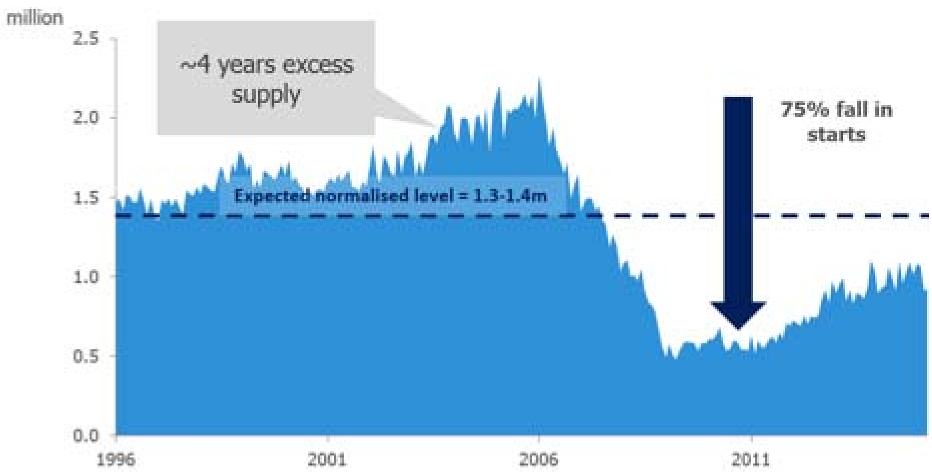
A property fire sale by investors or developers could lead to large falls in prices and capital losses, rendering many developers insolvent. China's property industry is highly leveraged, and closely linked to the shadow banking system, creating potential financial system risks. Nearly half of China's debt is linked to the property market, and a large part of China's post-GFC credit boom was property related[5]. Local governments are increasingly buying land from themselves, via local government financing vehicles (LGFVs) using money borrowed from banks and shadow lenders as demand from property developers has collapsed. Many Chinese households have effectively lent to LGFVs via trusts and wealth management products (WMPs). Kaisa Group recently became the first Chinese property developer to default on its foreign debt, which could be a sign of things to come for the industry.

Real estate accounts for more than half of household wealth in China. If prices fall dramatically, household consumption will follow suit and some overleveraged households may be forced to sell. Household debt, around half of which is mortgage-related, has risen strongly from around 8% of GDP in 2000 to around 38% in 2014, but remains relatively low by international standards[6]. Interest rate liberalisation, capital account opening, and the availability of alternative investments could also undermine property market fundamentals.

IMPLICATIONS FOR CHINA'S ECONOMY

To work off the excess supply, it is possible that China's residential property construction activity could fall by as much as 50%. This would be on a similar scale to what happened in the US during its housing crash (Figure 3).

Figure 3: US housing oversupply led to a crash
US private housing starts



Sources: US Census Bureau; Magellan. Monthly data at seasonally adjusted annual rate.

Real estate and related industries account for 20% to 25% of GDP in China. The housing sector directly represents approximately 10% of GDP (approximately 50% more than the US pre-GFC)[7]. The bursting of the property bubble would cause fiscal balances to deteriorate, especially for local governments which rely on land sales for around 35% of revenues. Indeed, the IMF estimates that China's fiscal deficit would be 10% of GDP if land sales and market financing of LGFVs were excluded. A large contraction in China's property sector would cause a major slowdown in the economy and perhaps even a recession.

The Chinese government is hoping that the housing adjustment can be managed gradually, supported by economic stimulus measures, bailouts and orderly defaults by property developers. Additional investments in social housing may form part of the solution, and the recent loosening of lending restrictions is likely to be extended. Housing subsidies and hukou reform may be used to enable migrant workers to purchase homes in the cities where they work. If panic selling ensues, the government could attempt to shut down the market, as we saw with Beijing's recent stock market intervention, or nationalise a portion of the excess housing stock to help restore balance to the market.

Of course, property is more than an economic issue in China. A disorderly bursting of the property bubble represents a potential threat to the Communist party's mandate to govern. For this reason, it is likely that the Chinese government will use strong policy intervention in the event of a market panic. State intervention has its limits, though, and any actions to shut down or nationalise the market could prove very costly and have unintended consequences for economic activity. Ultimately, the housing market is driven by millions of private sector buyers and sellers - even China cannot escape the basic laws of supply and demand.

A range of indicators suggest that China's economy is slowing, perhaps somewhat more quickly than official figures imply. Further, domestic weakness in China is flowing through to asset markets around the world, particularly commodity markets. Although economic data out of China is problematic, there are a number of indicators that suggest a slowdown is already underway. Electricity consumption grew by 4% over the year to June 2015, compared to 12% growth per annum from 2009 to 2013 (Figure 4 over page). Steel production, cement production and rail freight traffic have all slowed materially or contracted in the year to June 2015. Import data shows that domestic demand is weakening[8].

Given the reliance of China's economy on housing and the associated industrial complex, China's recent GDP growth estimates are hard to believe. Despite stimulus measures undertaken by the Chinese government, multipliers associated with housing activity are likely to be large and generate significant knock-on effects for consumption and the broader economy. Furthermore, it is difficult to imagine a seamless transition in economic activity taking place from property in oversupplied lower tier cities and related industries, to services, as the official figures imply.

Figure 4: China's economy is slowing more than GDP data suggests

Average growth	2000-2008	2009-2013	Latest
Real GDP (%)	9	9	7
Credit (Financial Institution RMB loans)	14	19	15
Steel production	15	11	0
Electricity production	11	12	4
Cement production	11	11	-6
Urban housing completions	9	10	-15

Source: NBS

WHAT DOES THIS MEAN FOR MARKETS?

China is a key driver of global growth, and its importance to the global economy is only increasing with time. Since 2010, the country is estimated to have directly contributed around a quarter of total global economic growth, despite its economy only representing around 12% of global GDP. China is by far the largest consumer of commodities, accounting for around half of the world's consumption of iron ore, cement, coal and steel. Should China's economy continue to slow or face a hard landing, the global repercussions are likely to be significant. Now is a time to be cautious about exposures to China, particularly in the commodity and currency areas, given the adjustment process that is currently underway in the property market.

A number of commodity exporters such as Brazil, Russia, Australia and Canada have experienced material depreciations in their currencies against the US dollar as commodity prices have fallen. In some cases, these economies may also be vulnerable to the unwinding of commodities-linked domestic credit booms. The same can be said for a range of other commodity exporting emerging market economies, including Chile and others in Latin America. While many emerging markets are net importers of commodities, these countries' currencies may also be vulnerable to commodity price falls in the short term, due to highly-correlated exposures among global asset managers and recent, broad-based emerging market credit booms. Other economies with major trade linkages to China, such as the emerging markets in Asia, Japan and, possibly, Germany, could also be affected.

Although China's international financial linkages are relatively nascent, links between Chinese banks and Hong Kong or Singapore could provide channels for the international transmission of a Chinese financial shock. Foreign lending to Chinese corporates has grown at a rapid pace and much of this lending is focused on the property sector. Chinese property developers currently represent approximately one-third of Asian high yield non-financial corporate bond issuance and could trigger a reassessment of risk premia in the event of large scale defaults. If China experiences a recession and defaults spread across borders, an emerging markets credit crunch is not out of the question.

There is also a risk that domestic macroeconomic weakness may cause the renminbi to depreciate, following a 53% real trade-weighted appreciation since 2005. Further, capital repatriation by Chinese investors in the event of a recession could hit property markets in Canada, Australia, the UK and Hong Kong. China also has massive foreign exchange reserves and is one of the world's largest holders of US Treasury securities. However, the use of foreign exchange reserves for domestic purposes faces some practical limitations.

CONCLUSION

Fortunately, Chinese authorities are aware of the problems in the property sector and appear to be taking steps to manage the housing market correction and slow credit growth. Almost all of China's debt is held domestically and the country's capital account remains relatively closed, which makes it easier for the government to manage large-scale defaults as it did in the late 1990s. Additional fiscal stimulus or debt nationalisation is possible, with government debt at 56% of GDP. The country's huge foreign exchange reserves and current account surplus also make it highly resilient to external financial shocks. While the Chinese government has substantial resources at its disposal, it still may not be able to prevent a sharp slowdown in growth (or a recession) if the returns on incremental spending and investment are sufficiently low. While there are a number of reasons to be optimistic about China's long-term economic future, the short-to-medium term challenges are considerable. China's property bubble is set to burst and the global ramifications will be widespread, warranting a cautious approach by investors.

ENDNOTES

1. National Bureau of Statistics
2. RBA; Gavekal
3. National Bureau of Statistics
4. National Bureau of Statistics
5. McKinsey
6. McKinsey
7. IMF
8. National Bureau of Statistics

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