GROW Investment Group

GROW Research
China Market Strategy

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Can Property Save the Day - Again?

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- Chinese property sector now a zero-sum game and inversely correlates with the overall market. Property easing doesn't necessarily mean broad market rally.

- Property is highly correlated with China's macro savings rate. The lower the savings rate, the better the property sector. But leverage will also be higher.

- Hong Kong is cheap, with neutral to positive technical signs. Patience.

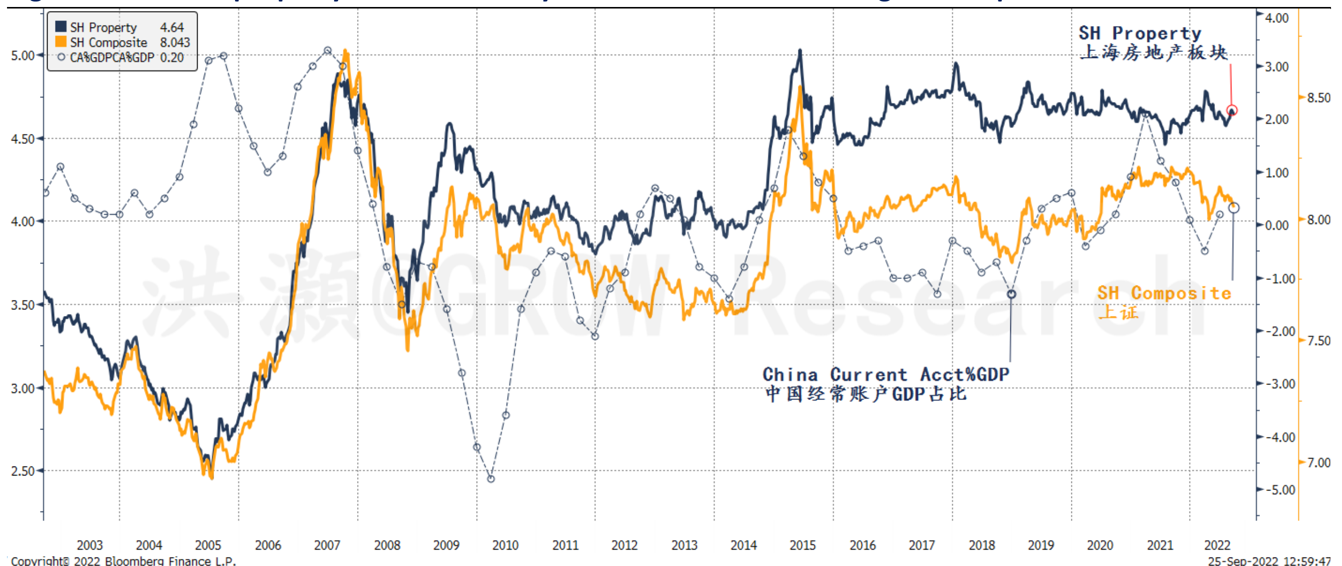
Chinese version:
《全球最大的资产 – 尚能饭否？》

Property Becomes a Zero-Sum Game

Last week was a week of epic global volatility. Market gyration was most palpable in the currency market, with the USD making close to 30-year new high, the Yen plunging to its second lowest post Plaza-Accord, the EUR weakening decisively below par and the Sterling breaking down. Meanwhile, the CNY is fast approaching the keenly-watched 7.2 level – a level seen during the 2018 trade war.

US market sentiment, as measured by record retail put buying, appears deeply depressed, and the market is nearing oversold level that historically argue for a technical rebound. But history is being re-written every day, and as such our quantitative models depending upon historical correlations between market factors have become capricious. Amid the torrents of market upheaval was the all-too-familiar call for China to ease on property. After all, it is one of the world's largest and most important asset classes.

Figure 1: Chinese property sector inversely correlated with the Shanghai Composite since 2019



Source: Bloomberg, GROW Research

While we empathize the sentiment, we note that the relationship between the property sector index and the overall Chinese stock market has changed since 2019. And hence the relationship between the property sector and the Chinese economy - if stock performance reflects the underlying economy.

In **Figure 1**, we show that the property sector has become inversely correlated with the Shanghai Composite since 2019. Recently, the property sector is trying to stage a rebound amid all the easing news, but the Shanghai Composite has failed to respond – contrary to the experience before 2019. Apparently, the relationship between Chinese property and Chinese economy has flipped.

To see the reason why, we can do a simple thought experiment with some macro, big-picture numbers.

From 1987 to 2021, China's urban population has grown from 275 million to 900 million, an increase of 625 million. As the NBS-reported average living area per cap is 35 to 40sqm, 625m newly urbanized population would mean a demand of 22 billion to 25 billion sqm of new residential living space. Interestingly, for the same period, cumulative residential sales were 23 billion sqm – roughly equal to the new demand from the growth in Chinese urban population.

Going forward, residential area under construction is 6 billion sqm. As the NBS-reported average size of residential unit is 110sqm, 6b sqm would translate into 55m new residential units. If urbanization rate would reach its 75% target from the current 64%, then it would mean 160m newly urbanized population. As the NBS-reported average size of household is ~3 people, 160m people would mean new demand for ~50m residential units. That is, property supply in the pipeline roughly equals potential demand from urbanization in the coming years.

Further, Chinese population growth has grinded to a halt. In 2021, new births were 10.62m, while deaths were 10.14m. 2022 will likely see negative population growth, more than a decade earlier than experts' prediction. With historical and future property supply and demand largely in balance, and little new demand for property from population growth, Chinese property has become a zero-sum game. It is no longer a game of growth, but more a game of re-dividing the existing pie.

China Macro Savings Rate and Property

In **Figure 1**, we have also shown another important macro relationship between property sector performance and China's savings, with the size of China's current account as a percentage of GDP as a proxy.

We note that the relationship between China's macro savings rate used to be positively correlated with property sector performance before 2019. But it has since inverted. This is another sign hinting at property becoming a zero-sum game. As people choose to save within their limited budget instead of buying property, property sector performance languishes.

Household's budget can be limited by the compensation of their labor not commensurate with their productivity growth and output, by excessive property price or both. The huge Chinese savings used to be able to spread as the liquidity for overall market and property sector performance. (We have discussed the relationship between Chinese saving deposits and the Shanghai Composite in our last note "***'Chill' about CNY Beyond 7***" on September 18, 2022) But now property has become a zero-sum game, as suggested by the relationship between market and property, as well as China macro savings rate.

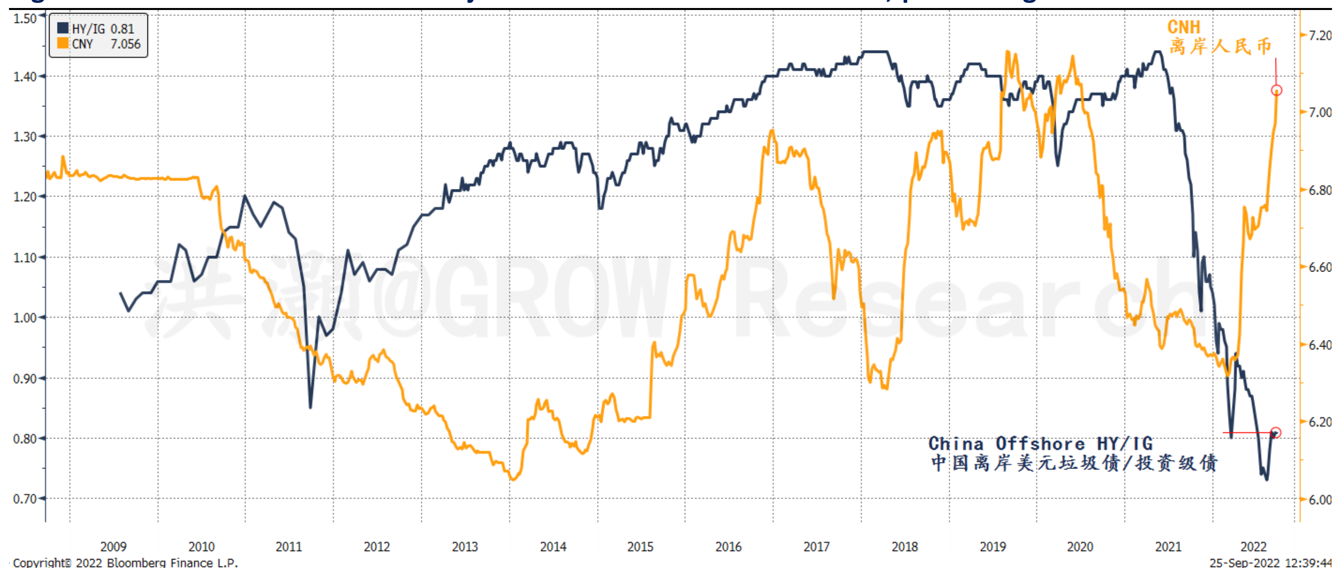
As such, even though now many "city-specific" property rescues have been rolled out, new home sales have not yet recovered. Most of these policies aiming at making it easier and more attractive to household to buy properties. That is, letting households to leverage up their balance sheets.

But China's property is both a supply and demand problem. There is an excess of supply, and insufficient demand. In March 2015, there was a similar approach to make households gear up to buy properties, while a policy bank expands its balance sheet for shanty town reconstruction. And we all know how that movie ended.

Off-shore Chinese USD Junk Bonds Faring Worse than 2011

Since the end of 1Q2021, Chinese offshore USD junk bonds have been performing poorly. Many of these bonds are issued by Chinese property developers who were trying to take advantage of the lower offshore USD financing rate, and were trying to replenish their cash coffers as the "three-red-line" limited their ability to leverage domestically.

Figure 2: Relative return of Chinese junk bond even worse than 2011; pressuring the CNY.



Source: Bloomberg, GROW Research

We measure the performance of these bonds by calculating the return spread between these junk bonds and investment-grade bonds. We can see that the spread has widen to its worst since the 2011 European Sovereign Debt Crisis (**Figure 2**). The current HY/IG

spread has priced in a lot of bad news in the property sector and has recouped a bit of losses recently amid property easing measures.

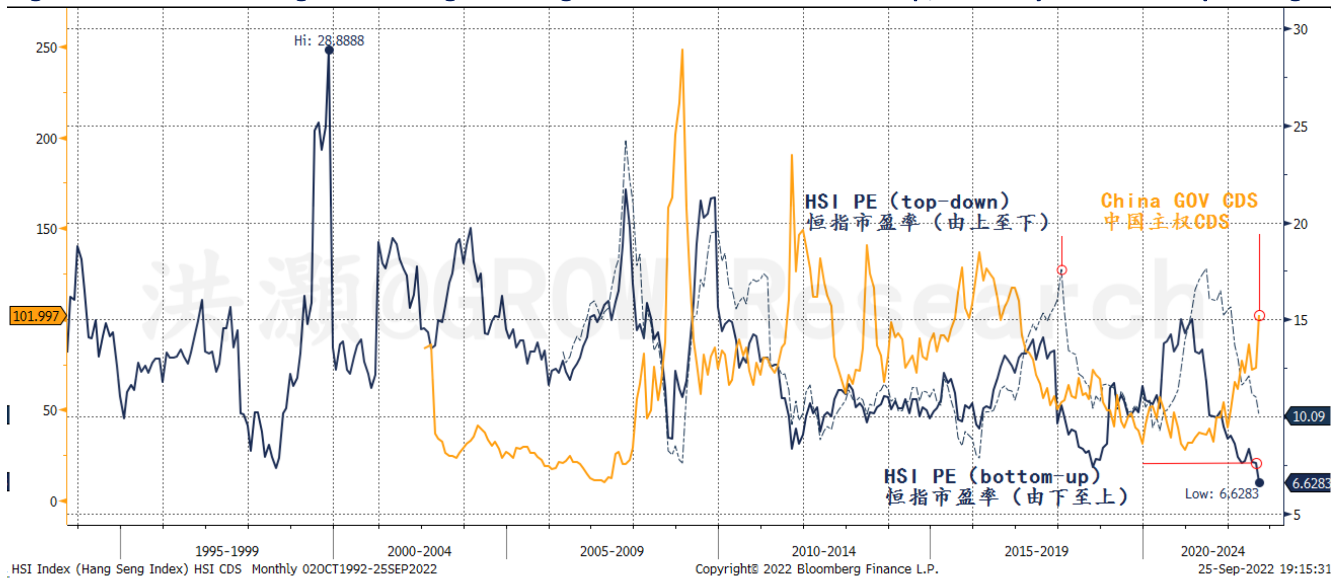
But we would argue that the challenges that we are confronted with are more significant than in 2011 when the property sector was a lot less saturated, China's balance sheet was less leveraged, and urbanization was still developing at a fast clip. It is important to note that 2011 is the year China passed its Lewis Turning Point and Kuznets Turning Point, with profound implications for the country's demographics and income inequality.

With the likelihood of the China offshore USD HY/IG spread continuing plumbing new lows, the CNY will continue to be pressured, as suggested by **Figure 2**.

Hong Kong is Cheap. But …

It is not all doom and gloom. We note that amid epic market volatility, broken key levels and massive put-buying volume, the P/E of the Hang Seng Index has plunged to all-time-low, when calculating with a bottom-up aggregation method by weighting the EPS of index constituents with corresponding market capitalization. But the Hang Seng's top-down, index level P/E, calculated by dividing total index market value by total index earnings, is still not at its cheapest (**Figure 3**).

Figure 3: China sovereign CDS rising to its highest since 2015. HK is cheap; but may not be cheap enough.

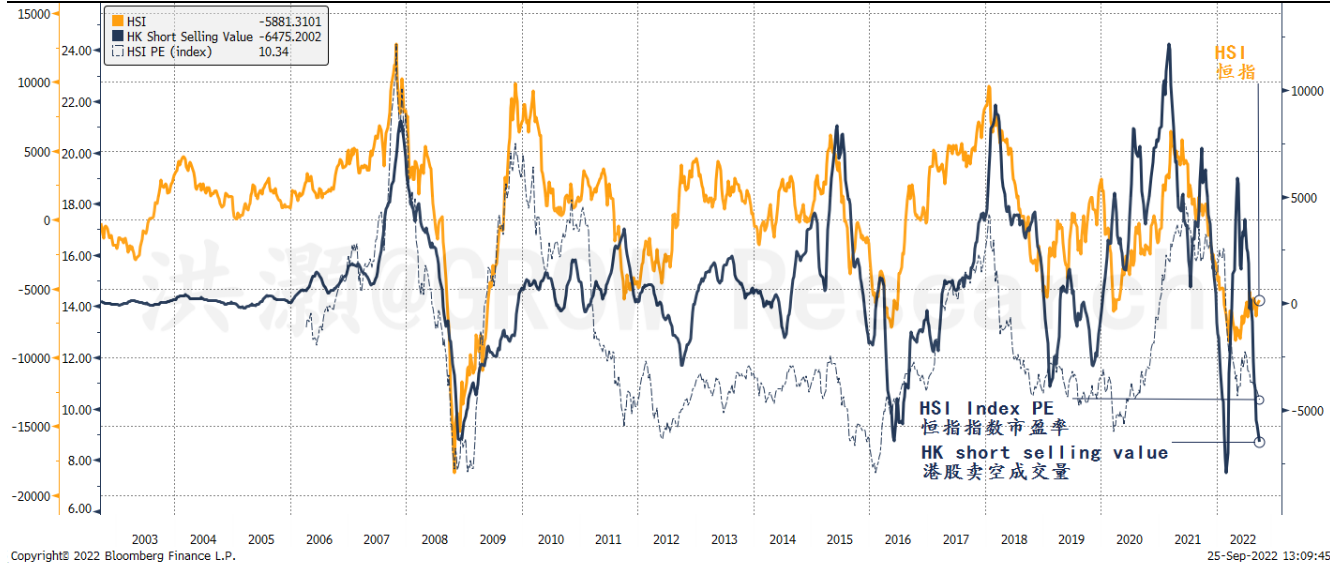


Source: Bloomberg, GROW Research

Meanwhile, China's sovereign CDS spread continues rising to its highest since 2015, reflecting a general risk-off environment. Although elevated, the CDS spread is still well below its highs seen in 2008 global financial crisis, 2011 European Sovereign Crisis and 2015 China's bubble burst. That is, risk is likely to continue rising, but the CDS spread and Hang Seng P/E have not yet fully priced in the looming contingencies. We were lured by the Hang Seng's cheap valuation at the end of March and called a technical rebound then. But now the risk near term is too great to justify a trading call. We would continue to stay

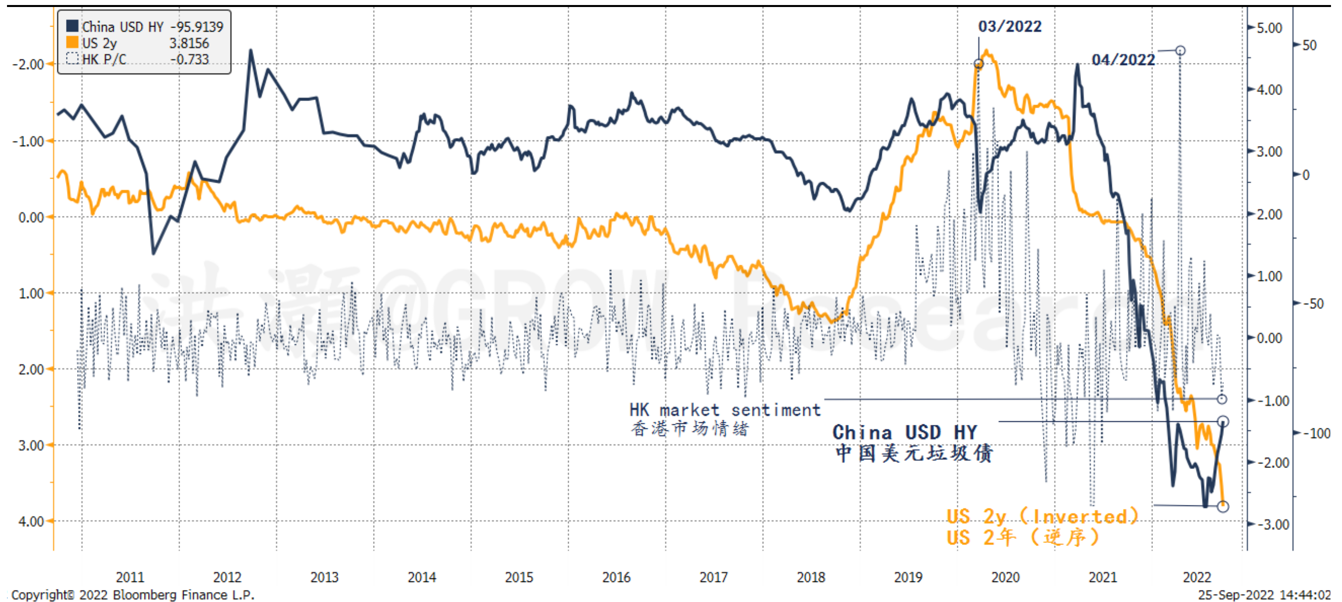
put. Traders have been reducing their short-selling positions in HK as the market plunges. Right now, this measure has fallen to one of its lowest in history that tended to coincide with market bottoms in 2008, 2016, 2018 and 2020 (**Figure 4**). Yet put option buying has been tepid, giving no strong technical indication either way.

Figure 4: Traders have been reducing short-selling positions to one of the lowest in history.



Source: Bloomberg, GROW Research

Figure 5: Chinese junk bond likely plunges further with US 2y; HK sentiment not extremely depressed.



Source: Bloomberg, GROW Research

Conclusion

The relationship between Chinese property and Chinese economy has changed. As property has turned into a zero-sum game, and the savings pattern changes, the more Chinese saves, the less will go into property instead of other risk assets.

Hence, we observe an inverse correlation between Chinese property sector performance and the overall market. Property easing may be a Band-Aid on the slowing economy, but its longer-term implications on Chinese household savings and leverage, as well as economic restructuring is far less encouraging.

After recent sell off, Hong Kong has become very cheap. But CDS is likely to rise further, junk bonds are likely to continue its underperformance, and pressure on the CNY will persist. Short sellers have been reducing their position to a level that tended to coincide with market bottoms, but market sentiment has not yet completely collapsed. The global turmoil is set to continue.

Just because something is on sale doesn't mean that we have to buy it.