China’s property sector – the road ahead

Fullerton Market Updates
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FULLERTON FUND MANAGEMENT

Executive summary

- The latest statements from Chinese policymakers and news reports suggest a shift in policy tone, and we anticipate that the worst of the Chinese property sector tightening is probably behind us.
- Looking ahead, we expect a further fine-tuning in housing policies to stabilise sentiments, but a broad easing of policy measures appears unlikely at this stage. The government remains committed to further deleveraging of the property sector.
- We do not rule out the possibility of more defaults ahead, but we hold the conviction that the short- term pains will lead to long- term gains. As struggling players are squeezed out, sector consolidation should take place, leaving the better quality, lower-leveraged property developers, which is medium-term positive for bond investors.
- We have been reducing our exposure to the Chinese property sector, particularly high yield developers we identified as being the most vulnerable in the challenging financial conditions, as part of our risk management efforts. We expect market volatility to persist and managing tail risks will be crucial.

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China’s regulatory efforts and turbulence in the housing sector have made headlines recently. Likewise, Fantasia’s unexpected USD bond default also pushed spreads of Chinese high yield dollar notes to a recent high. Separately, China Evergrande Group’s payment of an outstanding USD coupon offered some temporary relief for the Company, which may be short-lived, with a significant amount of liabilities still to be paid.

Encouragingly, contagion risks stemming from the Chinese property sector appear manageable so far. The Chinese authorities have been increasing liquidity injections to avert a funding squeeze and repo rates have largely fallen in recent periods. Spreads across the Chinese dollar financials, and Chinese high yield industrials issuers, have been well-behaved. The Chinese yuan is also holding steady. Likewise, Chinese onshore credit spreads, barring select high yield property issuers, are also holding up.

Notably, we observed that the latest statements from several Chinese policymakers and news reports seem to suggest a shift in policy tone. Some marginal easing of policies, such as the acceleration of mortgage approvals by banks, and reduction in home loan interest rates, appears to be occurring, predominantly at the city or local government level, which is encouraging.

On the same note, we anticipate that the worst of the Chinese property sector tightening is probably behind us. Looking ahead, we expect a further fine-tuning in housing policies to stabilise sentiments, but a broad easing of policy measures appears unlikely at this stage. We noted that the Chinese authorities continue to push forward with the property tax proposal despite a slowdown in the housing market, underscoring Beijing’s commitment towards further deleveraging of the property sector. That said, given the strategic importance of the property market, which accounts for around 25% of the country’s GDP[1], we do not believe that the Chinese government desires to push the property developers to the brink of default, which would potentially lead to a widespread sector meltdown.

Likewise, we also believe developers' concerns are being closely monitored and a further escalation seems unlikely. For example, the National Development and Reform Commission (NDRC) has been engaging with developers who are large dollar bond issuers, according to Bloomberg. Most recently, according to onshore Chinese media outlet Yicai, the Shanghai branch of the State Administration of Foreign Exchange (SAFE) has also asked property firms to report any offshore debts that mature this year and to outline repayment arrangements. We believe these are critical steps taken by the Chinese regulators to stabilise confidence levels in offshore markets and serves as an important reminder to developers on the need to fulfil their debt obligations.

Broadly, we expect the theme of "housing is for living, not for speculation", and "stabilising land prices, home prices and housing market expectations", to remain the key objectives that will drive China's regulatory framework for the property sector. This theme will also extend to property-related regulations on financial institutions, including banks and local governments, to rein in speculative demand, reduce leverage and stabilise property prices.

While we do not rule out the possibility of more defaults ahead, we hold the conviction that short-term pains will lead to long-term gains. Although the tighter financing conditions and constrained access to funding channels could put pressure on weaker Chinese real estate developers, we believe stronger companies that have robust balance sheets, or demonstrate better adherence to the "3 Red Lines", will be well-positioned to gain market share. As struggling players are squeezed out, sector consolidation should take place, leaving the better quality, lower-leveraged property developers, which is **medium-term positive for bond investors**.

We expect market volatility to persist and tail risks to stay elevated. As part of our risk management efforts, we have been reducing our exposure to the Chinese property sector, focusing on the high yield developers our analysts have identified as being the most vulnerable, amidst the challenging financial conditions. On that same note, we have been rotating into more defensive markets such as utilities, financials, oil and gas, as well as select commodity names alongside the firmer commodity prices. Likewise, we expect Asia ex-China markets – as they are just recovering from the delta variant slump which should boost credit fundamentals – to be better supported, as investors look for more opportunities outside the Mainland. Within China, we would favour Chinese SOEs, government-linked issuers, and investment grade financials. Notably, we observed that Chinese investment grade bank bonds have been holding up well, with credit spreads stable, underpinned by onshore investor demand, as they rotate towards more defensive sectors.

While we acknowledge that valuations, particularly in the single B Chinese property segment are relatively attractive, we believe headlines on potential defaults and policy direction will dictate spread performances as we head into year-end. We prefer to stay with the "BB" and stronger "B" names in the Chinese property sector, until there is higher conviction that tail risk concerns are waning. Likewise, we expect increasing credit differentiation amongst the high yield developers with the healthier names supported by better buying, while the smaller developers may have a greater chance of debt restructuring. That said, we are also cognizant investors' sentiments and market technical can shift markedly, with the lower-rated single B names likely to benefit the most. We remain vigilant and some of the key signposts we are monitoring closely include housing starts, contracted sales, inventory buildup, property prices and land auction premiums. A significant downshift in these indicators could motivate a more meaningful policy response from the Chinese authorities.

Similarly, if the Chinese government can maintain the stressed developers' operations as a going concern and keep the projects running through the introduction of SOE or local government investors. In that case, it is likely to lift the domestic property buyers' sentiments and limit the earning slump for the broader property sector. We are also encouraged by reports that the Ministry of Housing and Urban-Rural Development of China are drafting rules to strengthen supervision of property developers' pre-sale funds, which will mitigate the risk of unfinished property projects, and protect homebuyers' interests.

Looking ahead, we expect China's growth to improve in Q4, following the disappointing Q3 performance which was marred by poor weather conditions, COVID-19 outbreaks, energy curbs and tighter policy posture. China's TSF growth is likely to have bottomed and should rise accordingly. While the recent PBOC policy statement diminishes hopes of further RRR or policy rate cuts this year, targeted operations such as MLF and OMO to ensure liquidity conditions remain stable, are still probable. Overall, an easing of energy shortage, additional fiscal support through government bond issuances and resilient manufacturing performance, should potentially lend support to a better Q4 growth outlook.

[1] Source: 29% was the estimated share by Rogoff and Yang, NBER Working Paper, August 2020. While Eftimoski and McLoughlin, RBA, March 2019, estimated 20%.

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