Update on China's property sector

Fullerton Market Updates

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Executive summary

- China is likely to maintain a neutral monetary policy stance. Liquidity management remains the key policy tool and we think peak fiscal tightening is behind us.
- Chinese policymakers are expected to maintain a tight grip on the property sector, despite the recent reserve requirement ratio (RRR) cut; the pace of its deleveraging has been relatively slower than other sectors.
- The macro-policy measures taken should help ensure stable growth and prevent excessive risk build-up for the real estate sector, which are positives for bond investors.
- We expect credit bifurcation and market consolidation among the Chinese property players to persist.
- We believe the Chinese government is likely to intervene and keep liquidity ample if there are signs of heightened credit risk or stress in the credit markets.

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After China's solid economic recovery from the pandemic, Chinese policymakers' focus has turned towards strengthening fiscal discipline, and ensuring medium-term growth sustainability. We view the recent 50bps RRR cut as a fine-tuning of China's policy stance, rather than a start of an easing cycle. We believe macro-economic policy will be largely date-dependent and expect China to maintain a neutral monetary policy stance. Liquidity management remains the dominant policy tool while we think rate cuts are not yet in sight. At the same time, any fine-tuning measures could help mitigate potential downside growth risks as the year progresses, which is encouraging.

In contrast, we think peak fiscal tightening is behind us. We expect a pick-up in infrastructure investment in 2H 2021, alongside the higher local special government bond issuances. Developed market demand is likely to stay healthy, benefitting China's exporters and manufacturing investments. China's vaccination program has vaccinated about 50% of the population and the country is on track to inoculate at least 80% of the people by year end. The accelerated pace of vaccination would potentially reinforce the country's domestic consumption and services activity recovery in 2H 2021.

In terms of our property sector outlook, we expect the Chinese policymakers to continue to maintain a tighter grip on credit-intensive sectors, such as the real estate industry, despite the recent RRR cut. The Chinese property sector's deleveraging pace has been relatively slower than other sectors. Moreover, property and land prices are still elevated. To that end, the news on the latest rounds of macro-policy measures on the Chinese property sector are not new, as we have seen with the Three Red Lines implementation, cap on bank loans to Chinese property developers, and new land auction rules.

Likewise, the Chinese government's recent clampdown on sectors, such as the private education industry, appears to target the country's long-term growth and policy goals, including a falling birth rate and social inequality. Elevated residential prices, mortgage burden of households, and exorbitant private tuition costs are leading to a declining birth rate; healthy population growth is needed to drive the country's growth engine forward. High property prices and costly private tuition expenditure also favour the wealthy and widen the social-inequality gap in China. Notably, we believe the Chinese government's key objective is to ensure stability in the domestic property sector. This extends to land and property prices rather than a complete melt-down, especially in a country with one of the highest home-ownership (est. 90%) globally. Over time, these policy measures would potentially help ensure stable growth and prevent excessive risk build-up for the real estate sector – which are positive developments for long-term bond investors.

With that in mind, we expect the bifurcation and potentially heightened default risks among the Chinese property credits to persist. As a result, access to funding among some of the weaker issuers could turn more challenging. In contrast, property developers with stronger fundamentals who progress towards complying with the Three Red Lines policy, and with access to diverse funding channels, will be more favoured. We also expect more market consolidation among the Chinese property players. Those who have adapted to the tighter policy measures more quickly may be poised to take market share, while the smaller developers may struggle to keep up.

Within the Chinese high yield property sector, credit spreads had widened notably for the lower-rated single B credits. We expect market support towards these names to remain weak until the market overhang from the Evergrande saga eases. Our investment bias is towards the better quality BB bloc credit despite the cheaper B bloc valuations. Our Chinese high yield exposures are also concentrated in the front-end of the curve, where carry is attractive and duration risk is moderate. Our emphasis remains on active credit selection and the minimisation of adverse credit events.

Importantly, we are confident the Chinese authorities are likely to intervene and keep liquidity ample if there are signs of heightened credit risk or stress in the credit markets.