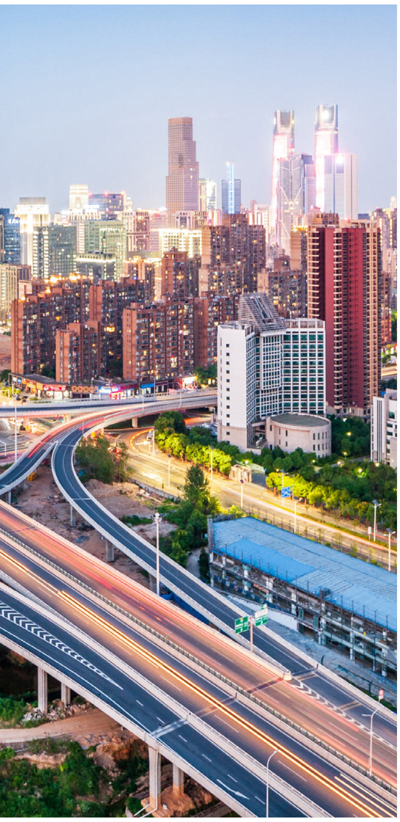
China's property sector: a step in the right direction

Fullerton Market Updates

January 2022



Executive summary

- Asian credit got off to a rocky start, marred by a series of idiosyncratic credit news which further dampened confidence in the Chinese property sector.
- We observed a distinct shift in policy tone, which suggests more policy easing could be on the cards, such as a mix of increased lending facilities, window guidance to banks, interest rate reductions, and/or RRR cuts.
- The recent policy developments are a step in the right direction for the property sector. They send a clear signal that the Chinese authorities recognise the stress in the embattled industry.
- Our focus is on managing idiosyncratic credit risks. The latest policy actions should limit contagion in the sector but may not be in time for some developers with immediate funding needs.
- Further progress on M&A activities, increase in bank lending and stabilisation in the physical property sales will be critical in sustaining the momentum.

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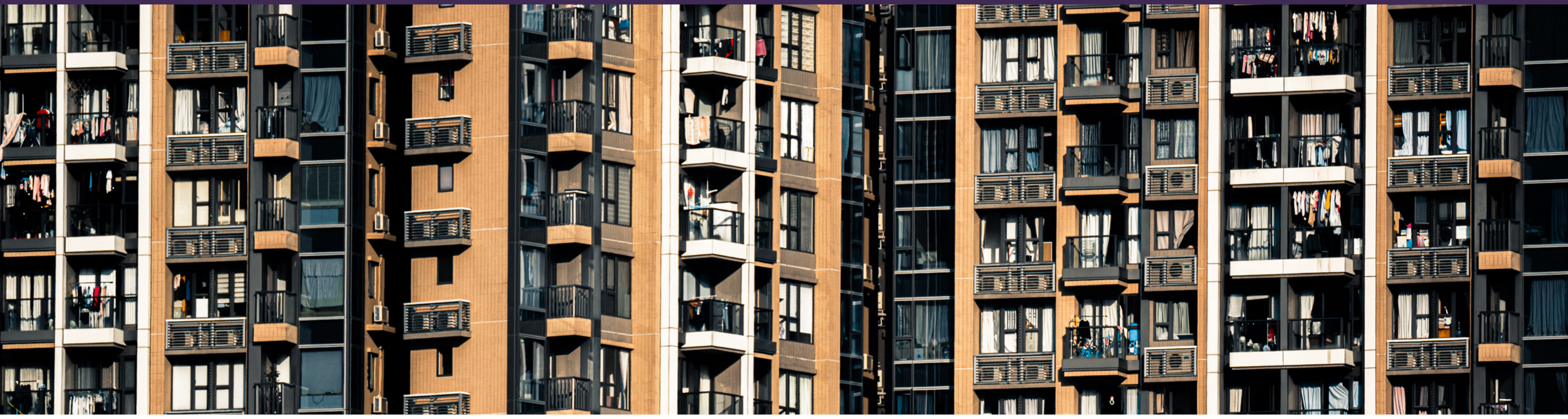
A rocky start to 2022

The Asian credit markets have had a rocky start to 2022. The year began with a series of idiosyncratic credit events dominating headline news. Notably, Shimao Group, which was previously on the cusp of investment-grade ratings, was downgraded several notches by the rating agencies. Elsewhere, delays on asset sales, announcements on bond extensions and debt exchange, hidden onshore debt surfacing, and yet more cases of rating downgrades further dampened confidence towards the sector.

We also observed a broad selling of Chinese property bonds in mid-January. Both catalysts led to significant price moves across many property names and later broadened to encompass the higher quality, lower beta developers that were previously relatively shielded from the selloff.

Distinct policy shift to stablise growth as China downshifts

On a more positive note, we observed a notable shift in policy tone, which suggests more policy easing could be coming. There appears to be an increased urgency from the Chinese policymakers to address downside growth pressures, driven by a property slump and repeated virus outbreaks. On 15th January, the People's Bank of China (PBOC) cut its 1-year Medium-Term Lending Facility Interest Rate (MLF) for the first time in 2 years – a stark policy divergence from other major economies – to help bolster its economy. The PBOC also pledged at a recent press conference to "open its monetary policy toolbox wider, maintain stable overall money supply and avoid a collapse in credit." Most recently, the PBOC cut the 1-year and 5-year loan prime rates (tied to mortgage loans) by 10-bps and 5-bps, respectively. Likewise, this marked the first-rate cut on the latter since April 2020.



Overall, we believe the PBOC's recent actions signal a distinct step-up in dovish guidance, which has been building since the annual Central Economic Work Conference (CEWC) meeting in December. This opens the door to more policy easing, potentially in Q1, through a mix of increased lending facilities, window guidance to banks, interest rate reductions, and/or RRR cuts to support growth. We think another 10 bps MLF (policy rate) cut is probable in the coming periods.

A step in the right direction for the embattled property sector

The latest policy developments are also encouraging for the property sector. This includes a Reuter's news report that the Chinese authorities are drafting nationwide rules to make it easier for property developers to access pre-sale funds held in escrow accounts. If this happens, it could help ease a severe cash crunch in the housing sector.

In China, when real estate companies sell residential properties, they must deposit the sale proceeds in supervised bank accounts before construction is completed. These escrow accounts, which can be drawn down according to construction progress, are typically supervised by the municipal governments to ensure project completion.

Following the China Evergrande's collapse in 2021, many local governments tightened supervision and curbed withdrawals from the escrow accounts, worsening cash flow for developers. Therefore, relaxation of the escrow accounts would release a critical channel for developers to manage their financing needs. In addition, PBOC is reportedly working to facilitate mergers and acquisitions among developers. Although the recent 5-bps cut in loan prime rate disappointed some market watchers leaning towards a 10-bps reduction, it still indicates a policy boost for the housing sector.

We are cheered by the latest policy direction; managing idiosyncratic credit risks is key

In summary, we believe the recent policy moves are a step in the right direction. They send a clear signal that the Chinese authorities recognise the stress in the embattled sector. They are willing to fine-tune policies, stabilise the industry and potentially engineer a soft-landing outcome. While a complete relaxation of the escrow accounts is unlikely and will undermine the Chinese authorities' medium-term goal of deleveraging the housing sector, some correction of the local governments' overly tight practices will still help ease the developers' liquidity pressure.

Overall, we are cautiously optimistic about the Chinese property sector, focusing on managing idiosyncratic credit risks. We prefer to stay with the higher quality developers, given the large maturity wall in January, March, and April. While the latest policy actions should limit contagion in the sector, they may not be in time for some developers with immediate funding needs. The actual implementation could also be taxing, and the transmission to the property developers may take some time to affect. Therefore, managing tail risks remain the key investment focus, particularly in the high yield sector.

Looking ahead, it will be essential to monitor the details of the new rules surrounding escrow cash accounts, which are widely expected to be published before the Lunar New Year. In addition, further progress on merger and acquisitions activities such as SOE developers stepping in to take over assets and providing a lifeline to privately-owned developers, an increase in bank lending to developers and households on property loans, together with stabilisation in the physical property sale markets, will also be vital to sustaining the momentum.