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Special Report: China's property market – disaster or opportunity?

David Woo, principal of davidwoounbound.com and former chief macro strategist for Bank of America/Merrill Lynch, co-hosted a roundtable with Greifenberg CEO David Goldman. Participating were three distinguished Chinese economists, identified only generically here: The director of an important policy think tank, the chief China economist for one of the world's largest private equity funds, and the chief economist of a major Chinese financial institution. All the participants spoke freely about the challenges and opportunities in the Chinese economy and the likely actions of the government.

The symposium was organized under the auspices of the Asia Times, the largest pan-Asian English-language news platform

Key takeaways:

- The property crisis was instigated by the government, and the government will keep it in control
- Global investors will become a major source of financing for China's property market, especially in the rental space
- Xi Jinping's crackdown on overly levered developers and rent-seeking big tech companies will clear the decks for a tech boom in 2023

Is the real estate crisis in China a disaster or an opportunity?

David Goldman: I'd like to start by posing a question. A couple of hours ago, Bloomberg published a report quoting the Singapore Sovereign Wealth Fund, which says that it's now very interested in investing in residential property in China because they believe that the rental market is going to be an important provider of housing for China, and they think it's a good place to invest. You, of course, work with one of the great private equity funds. How do you think international investors look at the property market? Our question was, is this a disaster or an opportunity? I guess it's partly both, but I'd be very interested to hear your views on how this looks from an investment standpoint.

No systemic crisis for China: This is a managed crisis provoked by regulators. Fundamentals are healthy

Chief China economist of private equity fund: Indeed it is both. From a property developer's point of view, it's a change of regime. First of all, I think China is experiencing a housing crisis at this moment. Most of the top private developers are experiencing financial difficulties. I think that this is mainly because of the regulatory crackdown or what we call overly tightened financial conditions for the developers last year. I think this is mainly because after the Chinese economy recovered [from COVID], the government, imposed more stringent financial regulations on the developers, with the intention of reducing their leverage. That follows the principle that houses are for living, not for speculation. Before the 20th National Congress, officials and regulators try to compete to change regulations, and then crack down on the leverage for the households. That's the fundamental source of the current crisis in the property market.

If we look at the long term, the issue still is urbanization. It will be slower but still continues. We still need to accommodate 200 million people to live in urban areas. China's average floor space per capita is around 35 square meters, which is not really large by global standards. Chinese households have the expectation that housing prices will deliver a high return.

We don't really think that this is the end of the Chinese property market. This is certainly not the style of Japan in the era after the bubble burst, during the late 1980s and early 1990s. That had a big social cost, due to the high leverage of Japanese households in the past twenty years, China's households did accumulate leverage. However, in the past 3 to 5 years, macroprudential regulations really affected households. Leverage accumulation was much at a much slower pace and the housing price rose at a much slower pace as well. This comes not from the demand side, in the sense of bursting of a consumer bubble, but rather from the supply side, the regulatory crackdown on the developers. That is certainly what created the current crisis. We still see that the LTV ratio in China is very low, household leverage is relatively reasonable and the housing price increase, although for many Chinese households, has moderated.

So in that sense, we don't think that that is a systemic crisis for China. The Chinese government still needs to invest a lot, but it is resolvable. It's not really like a two-decade-loss for China as in Japan. There is a crisis, but it is mainly due to the supply side Secondly, as I mentioned earlier, China's overall urbanization rate continues to grow, although at a slower pace. We still have 200 or 300 million people to move to urban areas. We calculated that 4.5% to 5% growth in property investment a year is reasonable. That incorporates depreciation in older buildings. So in this sense, we think there are still huge opportunities in the multifamily business in China.

David Goldman*:* Where do you think global investors would find an interest in the market? I mentioned the Singapore interest and rental property. Is this something I don't want to dig into your private business, obviously, but do you think that the large sovereign wealth funds, and private equity funds will become investors in Chinese rental property?

Global investors will cherry-pick assets that Chinese developers are forced to sell

Chief China economist of private equity fund: Yes. In this sense, we think there are two major opportunities from global investors. One I mentioned is multi-family business, that is, apartments. We are not developers. We don't build the buildings. But for those developers, they have buildings already built for multifamily businesses. China's consumers want to upgrade. For example, people work far from their homes. There will be demand for apartments closer to the workplace.

Secondly, I think we know that the Chinese developers are experiencing a very hard financial position at this moment. Some of them diversified their assets into other industries. I think it's time for us to do some cherry-picking, as they are forced to sell some of their assets. I think some of the assets are of interest, for example, in the consumer sectors, like the EV battery sectors. In this sense, it's also good for the opportunity for global investors. So there are two opportunities from our standpoint.

David Goldman*:* A wise man once said that the purpose of financial crises is to put assets into the hands of people who deserve to own them.

Let me ask you a question about the Chinese capital markets. In the past ten years, the price of homes per square foot in China has more than doubled. And the single best investment bet that Chinese households have had is in housing. Now, of course, that's decelerated. It may even come down a bit in terms of the investment preferences of the Chinese public. Is it possible to persuade the Chinese people to invest in stocks and bonds in capital markets the way, say Americans do, as opposed to principally in homes and bank deposits? Can that change? Is that change possible? Do you foresee it?

Chief China economist of private equity fund*:* As I mentioned in the beginning, this is a regime change. Previously, Chinese households concentrated most of their assets on housing. Even if we include the deposits and the stocks of pension funds and also insurance, then in China, I think around 60 to 70% of household assets are concentrated on housing. That leaves only 30% on the financial side. And 20% is bank deposits. Only 10% of their household assets are in stocks. Going forward, I think, as I mentioned at the beginning, that this is a regime change. The capital gains from housing are really a thing of the past. Five years ago, we thought the price of our house could double. Now nobody believes that. So only the question is to satisfy demand. People will buy a house for their child to be educated in a certain area, or because the family is getting bigger. Housing demand will be driven by fundamentals rather than speculation.

Secondly, as we know, generation Gen Z, this generation, their parents already have a house. So Gen Z is they will mostly invest their assets in financial securities.

David Goldman*:* This is extremely interesting. I have two questions. First, I'd like to you as a capital markets economist, how you see investment behavior and the Chinese capital markets developing. And then I'd like to ask about the politics of the property situation, particularly as it affects the finances of local governments and the financing sources for public activities in China generally.

Key to investing in Chinese stocks is to select growth

Chief Economist for Major Financial Firm: Uh, okay. Stocks are still a very small portion of the total investment of Chinese households. There's a complicated reason for those. The first thing is that the stock market in China, the history is very, very short compared to the global markets. And regulations and corporate governance problems have been a problem for a long time. Stocks have given very poor performance to households in the past decade. You have to be very, very selective in this Chinese stock market because this market has been expanding very fast. That's, I think, is sort of years from before that. Over 5000 companies have been listed. And if you look at the Chinese IPO market, a lot of companies actually get a very high IPO price multiple, and later on, they have a re-rating. It's naturally harder for Chinese stock investors to become deep-value investors.

The Chinese domestic market is a growth-driven market. Investors are more likely to pay a high multiple premium for these growth stocks. Not many people are actually interested in investing in stocks like banks or property developers or those like steelmakers because they don't expect too much earning growth from these companies, especially the state-owned companies. Investors are likely to invest in those growth-driven stocks such as medical or technology companies or new energy companies. The problem is that the valuation for those companies, even when they're first listed in this market, has been pretty high. So you have to compensate for those high multiples. And it takes years to digest those high valuations after their IPOs. So that's become a problem, I think, for the domestic market. And as a result of that, investors find that their return over a longer term in this market has not been very significant, higher than those like a savings rate. I made the compensation. I make a comparison between those two numbers. If you look at those investment returns, it's only in the stock markets that you only have an annualized return of about 3% over the last 20 years. But you can easily find a return of 3% in your banking deposit. If you look at the property market, the returns are much higher, about 7% to 8% annualized return in the past 20 years. So that's why so many Chinese domestic households like to put their money into the property markets.

That's also why the Chinese domestic investors believe the property price will not go down in the long term because that's a too big part of household assets. Even if there is only a 10 to 15% down in the total household value, that could be a major blow to the Chinese economy as well as China households in terms of their total assets. Land sales are also a very big portion of the total government fiscal income in China. So that's also made it harder for local government to tolerate a slowdown in the property market and a downturn in property prices. This has been a very challenging moment now because we see property sales down around 40% year on year, while land sales are also down over 40% this year. I think the government has to cope with this problem right now. If they don't do anything I think that there will be a major problem not only for the economy, but also for total Chinese household assets. Then that will become an asset deflation.

David Goldman: That was the political question I wanted to ask. How do you think the government in Beijing sees this and how will they respond?

The government will intervene in size

Director of Chinese Policy Institute: Well, that's a very good question. And I agree with the two economists. This is not only a property market crisis. The housing crisis, if there is one, is also potentially an economic crisis and also a social crisis in the end. So I think something must be done very quickly to stop the crisis from spreading into other dimensions of society. That's why you see the government responded very quickly responded to the situation in Henan Province, where a group of homeowners is refusing to pay their loans because the buildings have not been finished yet. The government has already 300 billion renminbi to focus exclusively on this crisis and finish the buildings. The government doesn't want this to develop into a sort of confidence crisis for society. There are a lot of special funds available from the Ministry of Finance, several hundred billion [RMB], and even more next year.

And so I think the government will do everything to make sure this housing market will be stable. It's not going to collapse. Under the very strong leadership of the central government, anything would collapse like that overnight in the Chinese economy. So I would still have some confidence in the property market.

David Goldman: David Woo, as a market-moving investment strategist with many years of experience in the Chinese market, how does all of this make you feel about investing in China now?

Xi Jinping is stuck with a bad COVID policy until after the Party Congress

David Woo: I think. Yes. I'm sorry. I think you know, listen, I think I'm trying to just focus on the big picture. I mean, what is the big picture here? The big picture is that Xi Jinping is about to be elected for his third term. Now, I would argue that to justify a third term, which is unprecedented in the history of communist China, he has to be able to argue that I'm prepared to do things that nobody else is prepared to do. He's prepared to be not very popular. Right. We know that in the last 30 years, Chinese presidents, especially in the second term, resort to more populist measures because they want to be remembered for good times and so forth. Xi Jinping ironically, in order to justify a third term, needs to show people that he is willing to make China swallow the medicine it needs for its long-term health.

If you want to be president for a very long time, you've got to make the case that somehow you're going to be better for China's long-term future. And then we all know, and Xi Jinping knows, everybody knows right now there are two big problems that China is struggling with. One is income inequality, which is destabilizing Chinese society. The second one is the collapse in birth rates. Housing gets to the root cause of both of these. House prices get so expensive that people cannot have more than one child. Because of rising house prices, Young people are going to get priced out. So from that point of view, Xi

Jinping's biggest challenge in his third term is going to be population growth, along with rising income inequality. I would argue that is the biggest challenge he faces.

This is the reason he decided to go after housing. He had no choice. He needs to somehow basically drive down home prices and convince people to think that on a risk-adjusted basis, maybe housing is not such a great investment. He's trying to kill that speculation. The problem is just like zero COVID. The guy got a bit complacent. Zero COVID is a great thing. I thought he should have ended it after the Olympics. He didn't. Right now, you cannot end it anymore, because his election is coming up in three months.

The biggest concern for me is that we just saw the latest Chinese consumer confidence number collapse. Even during COVID, even during the trade war with the US it never collapsed the way that has collapsed last month. Presumably, it's because of this housing situation.

To the extent the housing crisis is a manufactured crisis, due to the government crackdown on developers, they can make this crisis go away tomorrow. But the problem for Xi Jinping is that it will be a huge blow to his credibility. You cannot make the whole country suffer for a whole year and then turn it around and say, you know what, I don't care anymore. Let's go back to party again. You've opened Pandora's box, and I'm sure the intention is good. And I think if I were Xi Jinping, I would have done exactly the same. But the Chinese saying once you get on the back of a tiger, you cannot get off without being eaten by the tiger. Xi Jinping could become the casualty of an experiment that he unleashed himself.

When you have an authoritarian regime, when one person makes that decision, you cannot blame it on he cannot blame it on anyone else. He's the guy who made that decision. I think that the biggest problem that Xi Jinping is facing right now is, unfortunately, because we're close to his reelection, he actually cannot do the right thing. And unfortunately, that's the reason for me to sell China for now, at least until next early next year after the party Congress.

David Goldman: So we have a conundrum if. If housing prices fall too far, it will have a negative wealth effect and perhaps even effects on social stability if housing prices continue to rise, then we have a long-term problem that simply gets worse in the long term. Is there a happy medium? Is there any way for China to work its way out of this situation? There is one really good thing happening in China from my standpoint, which is a very high-level investment in high technology manufacturing. I think this is the one success that China can point to. CapEx on the part of China's largest tech companies will be up about 35%, in 2022 versus 2021 based on the bottom-up survey of Bloomberg analysts. And we see real strength in China's supply chains. We see that in the export numbers. China's exports to the United States are up about 50% since the Trump tariffs came in. And to the global south, Southeast Asia, and Latin America, they've nearly doubled. This is very impressive performance. And certainly, if China can raise its overall productivity by investing in high-tech manufacturing and services, it's possible to manage this problem. That's an optimistic take. Let me ask my colleagues whether I'm hallucinating something or whether there's something real there.

David Woo: I think that obviously, the problem with the tech industry is that it's not big enough to employ too many people. Tech is a great thing for China, for Total Factor Productivity growth. But in terms of raising average productivity, I think, you know, that's going to be a big challenge. I want to ask a basic question to our guests, because there's something I can't understand. If you want to dampen house prices, you want to increase supply and reduce demand. So if you want to increase supply, why are you out there trying to go after the developers? These developers are defaulting, they're going to go out of business, which means that there will be even less supply down the road.

Chief China economist of private equity fund: That's a good question. Who will be supplying the housing in China? I think going forward there will be consolidation among the property developers. There are about 40,000 developers in China. In the next few years, there will be maybe 2000 developers. That's good enough for China. So definitely, as I mentioned, again, this is a regime change. We don't really need so many developers in the housing market. You need to resolve the high leverage issue. Another source is the secondary multifamily business. I think in China, you know, investors like us can be the funding source. The third source is government. They acquire lands and then build housing. So that was one source of for the housing supply. Those are the three sources for future housing in China.

The bright side of the housing crisis: Opportunities for reform

David Goldman. Is there a benefit to this crisis? For many years, Beijing has wanted to rationalize government finances when local governments make most of their money on land sales. That's a very chaotic system of funding. And is it possible that the deficiency of funds going to local governments from land sales will be the starting point for reforms that make government spending more dependent on taxes and borrowing and the normal way this is done in other countries. China is the only country in the world where land sales are the major source of financing for local governments. It's a very unusual system. So could you see a rationalized government system coming out of this?

Director of Chinese Policy Institute: Yes, of course. In the long term, I think that's exactly the direction for China and for the Chinese economy. As was said earlier, 70% of our household assets are tied to our housing market, which is not healthy at all. The percentage has to come down. But how much, how quickly, is the debate. We want it to come down gradually. And as we move up the ladder, so to speak, as we transition into more high tech, to a more consumer-oriented economy, like most advanced economies. Our GDP is mostly still manufacturing-oriented, which is very important for China to sustain itself, to create jobs, and so forth. But a consumption-oriented economy is the future. That has to be done gradually, not too quickly or with a very high cost.

in the future, the taxes will come more from property taxes, from how many apartments, to how many houses you own in China. Several cities already started this part of the program very gradually because they don't want it to rush the program and crush the property market. So I think that's a very healthy direction. Of course, the devil is in the details. How you execute this new policy is the trick. So I think that's why a lot of people are worried about it. But I think as long as they can maintain control of the overall economy all these problems I think we have been seeing all these years, gradually and gradually will be more or less resolved. That's the Chinese economy. You know, a lot of people were very negative about the Chinese economy. Twenty years ago people said China is going to collapse. You hear that story every year. You're going to see a lot of problems facing the Chinese economy. I think muddling through is probably the more rational approach to the future.

Taking on Big Tech was the best thing Xi Jinping did

David Goldman: David Woo, I'd like to give you the last word. Let me ask you a question. It's December. The party conference is over. Xi Jinping has his third term. The political constraints are somewhat less. And he calls you and says, well, David Woo, now, what should I do now? What would you tell him?

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Speaker 2: I think China is sitting very pretty. I just finish reading, the report that came out last year by Harvard University that summarizes the state of rivalry between China in the US when it comes to technology, China now is very close to taking over the dominant position in global technology. I think this is a huge thing.

There's no doubt that China is now well ahead in terms of its ambition to overtake the US. And that's what's going to give China a higher standard of living down the road. There's no question about that. Also, that is going to deliver for China the ability to remain resilient against further sanctions from the US.

In the history of modern economics, in the last 100 years, there has been no other country that has grown as fast as China, where the stock market return has been as poor as in China. Why is it that the economy has done well, but the stock market or the companies themselves have not done that well? We're not just talking about all state-owned companies. There are a lot of private companies. 50% of companies are public companies and so forth. I can only assume until now China is like this Wild West, right, where companies were just themselves engaging in speculation. We know that many Chinese companies that were not even property companies, they were involved in property speculation. So I think from that point of view, it was a good thing what Xi Jinping did over the last twelve months, taking on the likes of Alibaba and Baidu. That's what Biden should be doing against Microsoft and Apple. These are monopolies. Companies like Alibaba were basically engaged in unregulated finance. Right. Companies like Baidu, Alibaba, and all these companies, they're like monopolies. They're stifling and killing competition in China. China needs innovation.

2023 is a great opportunity for Chinese tech stocks

So I actually think the best thing Xi Jinping did in the last two years taking on the big tech companies and putting them in their place and then trying to crush the developers and send them a message. Now, I think what China needs to do in 2023 is once they are put into their place, they have a great opportunity to therefore unleash the economy, let the economy do his own thing, and let companies make money so that the stock market does go up because companies are doing well so that people don't have to put all their money in housing. And then you can start with this virtuous circle. 2023 is going to be a great opportunity. This is why I think this bitter medicine China has swallowed over the last two years is going to be for China's long term. And I think, you know, I think that the only risk and danger is that China becomes a directed economy. I just hope we don't go down that path. If that risk is avoided and hopefully Xi Jinping will be able to avoid that, then I think China is in a very, very good position in 2023 and beyond just when the US about to go into recession.