

Key Questions for China Investors in 2015—Part III

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China is complicated and raises many questions for investors. On the one hand, its economy is growing more slowly—at 7.4% last year, compared to 7.7% for the two prior years. On the other hand, because the base was far larger last year, the incremental increase to the size of the economy was 100% greater than the increase a decade ago, when GDP rose 10%. This is why the International Monetary Fund estimates that China accounted for almost one-third of global growth last year. With inflation-adjusted income up 8% in China—compared to 2% in the U.S.—consumer spending is booming, up 11% vs. 2% in the U.S. Media headlines, however, continue to tell us that China’s economy is doomed.

This is the final installment of a three-part *Sinology* series designed to answer some of the most important questions about China’s economy. Today, we answer the question: is China’s property market heading for a crash? We also discuss what we feel are the biggest long-term risks to growth and stability—an absence of the rule of law and trusted institutions.

The first part of this series addressed the impact of falling oil prices and the risks for deflation. We also considered the prospects of certain policy moves—cuts to interest rates and bank required reserve ratios—that have led to a booming domestic Chinese stock market, and concluded that many domestic investors are likely to be disappointed.

The second part, published in late February, explored the reasons why the Communist Party is comfortable with slower growth, and just how slow a pace might be tolerable. That report also answered questions about the health of what has been the world’s best consumer story, and about prospects for further economic reforms.

Will the Housing Market Crash?

No, not in my opinion. China’s residential property market is significantly softer now. But I believe there is very little risk of a crash. House prices are stabilizing in China, and by 2H15 are likely to rise again on a year-over-year (YoY) basis. But keep in mind that because of the base effect, prices are likely to *fall* YoY at a steeper rate through much of 1H15, leading to a growing chorus of predictions of a housing crisis.

Official NBS Survey of New Home Prices in 70 cities

As expected since the late September policy changes, China’s market is stabilizing, but not rocketing back. Median new home prices, according to the National Bureau of Statistics (NBS) have been falling on a month-on-month (MoM) basis for eight consecutive months, but the pace of the decline is slowing: in December and January the median MoM price change was -0.4%, an improvement on the -0.5% fall in November, the -0.7% fall in October and -1% decline in September.

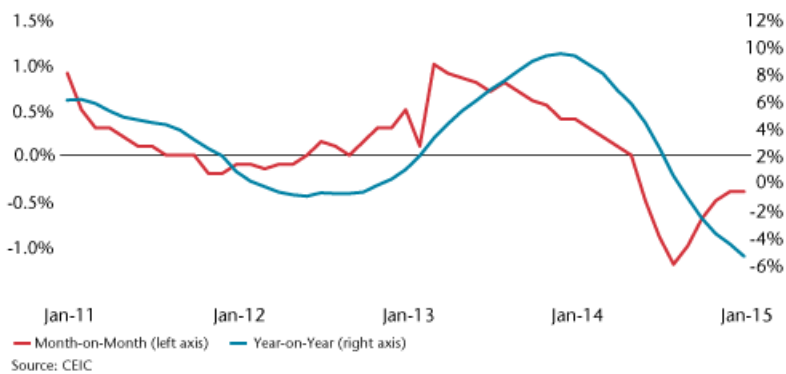
On a YoY basis, median new home prices in the government survey were down 5.4% in January, compared to -4.5% YoY in December, -3.75% YoY in November, -2.6% in October and -1.1% in September. Prices have been falling on a YoY basis for five months, and—because of the base effect (prices rose more than 9% last January and were up more than 5% YoY every month through May 2014)—even if the MoM price fall continues to shrink, the YoY decline would continue to worsen in the coming months. This is why it is important to look at both the MoM and YoY trends, and understand the base effect. Market sentiment is likely to be unnecessarily pessimistic through 1H15.

Among the 70 major cities covered by the official data, new home prices rose on a YoY basis in only one in January, Xiamen (+0.8% YoY). Zhengzhou—a city featured on many lists of “ghost cities”—had the smallest YoY price decline (-0.7%) among the 70 cities.

The six cities with the biggest YoY declines in January were Hangzhou (-10.5%), Shenyang (-8.4%), Shaoguan (-8.2%),

Guilin (-8.1%), Dandong and Quanzhou (-8%).

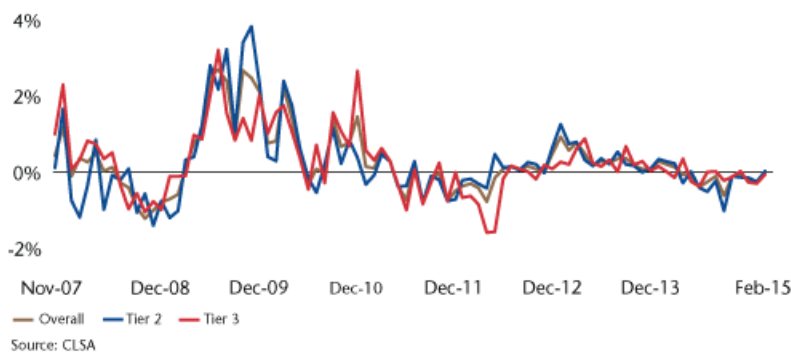
Figure 1. NEW HOME PRICES IN 70 CHINESE CITIES, NATIONAL BUREAU OF STATISTICS



CLSA New Home Price Data

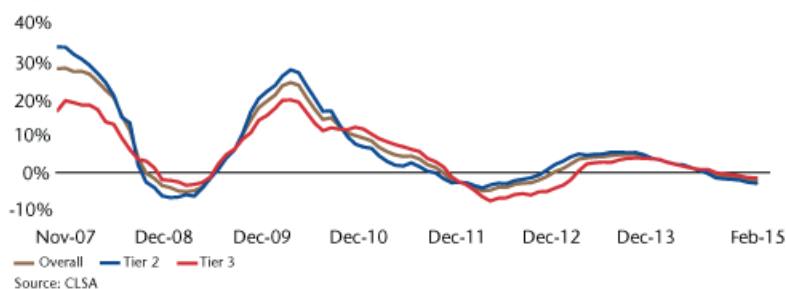
The research brokerage CLSA independently collects data on new home prices in a wide range of cities (excluding the “Tier 1” cities of Beijing, Shanghai, Shenzhen and Guangzhou, which account for only 4% of new home sales), and found that prices fell on a MoM basis for 11 consecutive months through February, vs. nine straight months of falling prices in the official NBS data through January. The CLSA data shows a similar recent trend of generally smaller MoM declines. In February, prices only declined by 0.02%, smaller than the January decline of 0.28% and 0.21% decline last December.

Figure 2. CLSA NEW HOME PRICES, MONTH-ON-MONTH



On a YoY basis, CLSA prices have fallen for six consecutive months through February, matching the NBS trend. In February, prices were down 2.1% YoY, vs. -1.9% YoY in January, -1.4% YoY in December, -1.2% in November, -1% in October and -0.7% in September. The base effect should also keep CLSA YoY prices in negative territory for some time, but the base isn’t as steep as that of the official data: CLSA prices were up 4.5% in December 2013, and were up about 3% to 4% in January and February of 2014.

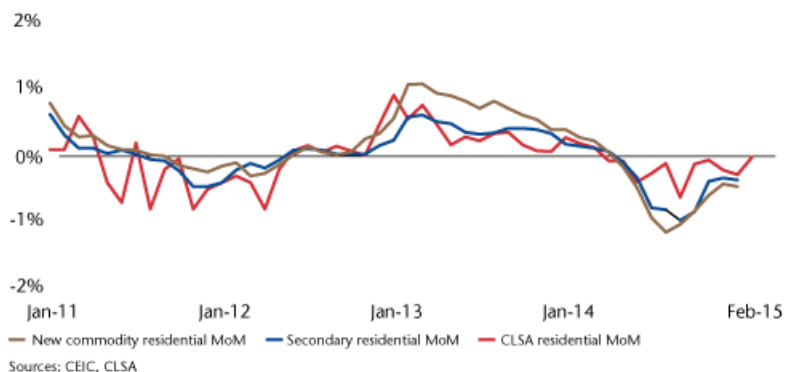
Figure 3. CLSA NEW HOME PRICES, YEAR-ON-YEAR



Secondary Market: Similar Trends

The following chart illustrates two points. First, prices in China's *secondary* home sale market are following a trend similar to that in the new home market: MoM price declines were smaller last December and January 2015 than in the previous three months. Second, the trends in the official data are very similar to the trends reported by the data collected independently by CLSA directly from sales managers at new projects across the country.

Figure 4. MONTH-ON-MONTH (MoM) COMPARISON OF PRICE CHANGES FOR NEW AND SECONDARY HOME TRANSACTIONS



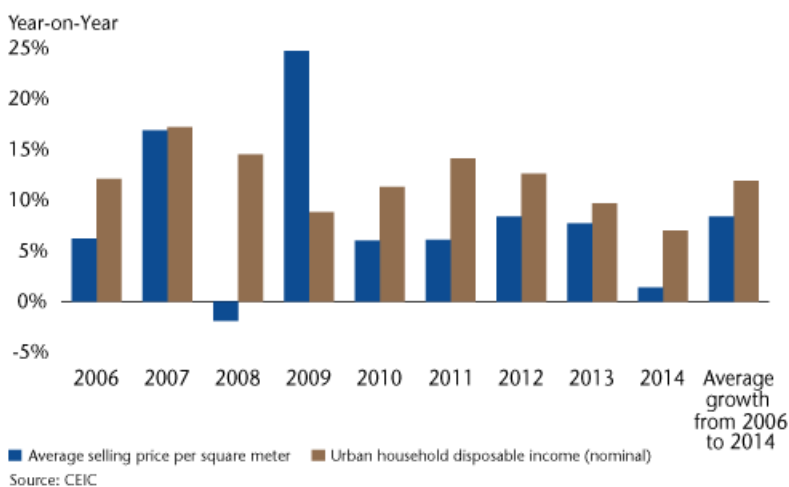
Softening or Crashing?

As the extent of the YoY decline in new home prices increases over the coming months—due to the base effect, even as MoM prices are likely to improve—the media may further trumpet the “China collapse” story.

However, it is important to understand that if, for several months, new home prices are down by, say, 5% YoY, there are a few reasons why this may not precipitate a crisis. First, because prices rose at an average annual pace of 8.4% over the last nine years, very few homeowners ought to be in the red. Second, new homebuyers must put down at least 30% cash, far from the 2% median cash down payment made by first-time homebuyers in the U.S. in 2006.

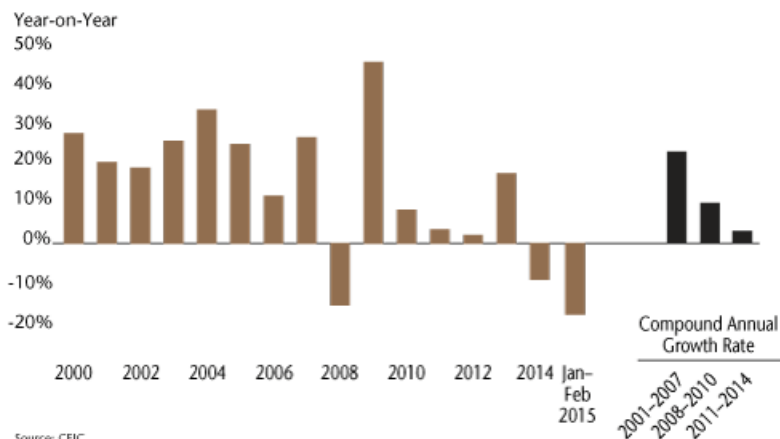
Moreover, the products that broke Lehman Brothers—and caused havoc through the U.S. financial system—do not exist in China. There are no subprime mortgages and there are very few mortgage-backed securities. There is no secondary securitization, so no collateralized debt or loan obligations (CDOs and CLOs). China's residential market is clearly very soft, but I believe a housing crisis is very unlikely.

Figure 5. HOUSEHOLD INCOME AND PROPERTY PRICE



In addition to soft prices, sales volume growth was also weak last year, down 9.1% YoY, after a very strong year in 2013, when sales jumped 17.5%. It is, however, important to keep in mind that even as sales volume fell 9.1% last year, that still means that Chinese families bought about 10 million new homes in 2014. That is a lot of new homes, and means there should be a few very profitable developers, especially given that the larger firms are gaining market share.

Figure 6. GROWTH IN SALES VOLUME BY SQUARE METER OF NEW HOMES IN CHINA



Source: CEIC

Sales growth is likely to remain weak this year, meaning that the growth rate of residential property investment could likely continue to decelerate in 2015. This is one reason I expect GDP growth to continue its gradual deceleration, to 6.5% to 7% from last year's 7.4%.

It is also significant that China's developers, which are largely privately owned, are responding to slower sales and rising inventories by slowing new construction: housing starts fell 20% YoY during the first two months of this year. The downside, of course, is that this contributes to slower growth in fixed-asset investment (FAI) and demand for construction materials, but this is already baked into my forecast for continued deceleration in FAI and GDP growth.

What is the Biggest Risk?

I am optimistic about China's medium-term economic prospects, within the context of expecting gradually slower year-over-year growth rates. This optimism is based in large part on the continuing evolution of government policy designed to embrace private enterprise and markets. My biggest concern, however, is that there has been little parallel evolution in China's governance and institutions.

China's economy and society are increasingly based on property rights, yet the country lacks the rule of law, which is needed to effectively protect these property rights and ensure a fair, rules-based commercial environment.

This is already the source of many problems. Corruption, weakness in industries dependent on intellectual property rights and the widespread theft of land from farmers—the main cause of protests across the country—are all consequences of the lack of rule of law.

In the near term, China can continue to thrive, as people find ways to navigate corruption and the opaque system, and as the Party works to reduce interference in the legal system by local officials. But as the pace of economic growth inevitably slows over the coming decades, China's unique form of authoritarian capitalism is unlikely to provide the necessary institutional support for a modern, market-based society.

There are, at this moment, no signs that the Party is preparing to establish the rule of law. The Party appears to want to continue to use the legal system to exercise its political control over the population, rather than to move toward a system that is designed primarily to protect the rights of individuals by limiting the government's power.

We do need to acknowledge, however, that back in the mid-1980s, when I first worked in China, it was not apparent that the Party was prepared to significantly relax its control over people's daily lives. But, a decade later, the Party stopped telling its citizens where to live and what to farm. In the mid-1990s, we did not expect the Party to dramatically shrink the state sector and pave the way for private firms to become the engine of growth. Private home ownership was not on the horizon. Today, most urban Chinese work for private companies and own their homes.

During the past two decades, the Party has surprised in many ways. It has taken a path that is unique among authoritarian regimes: relaxing day-to-day control over people's lives and commercial activities while strengthening the Party's control over the political and legal systems. This is a key reason why the Chinese Communist Party has outlived other authoritarian regimes. Constant, pragmatic reform of economic policy is also why GDP growth averaged 10% for two

decades before cooling to an average of 8% over the last four years.

Establishing the rule of law would require the Party to take another unique and dramatic step: to cede to its citizens some of the Party's control over the political and legal systems. Failure to take this step is not a short-term risk for investors, but I believe it will be key to China's economic prospects over the next 10 to 20 years.

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