Macro Update: Property Sector Inventory Update and Outlook

Shift to Policy Mix Needed to Maintain Destocking

February 15, 2017

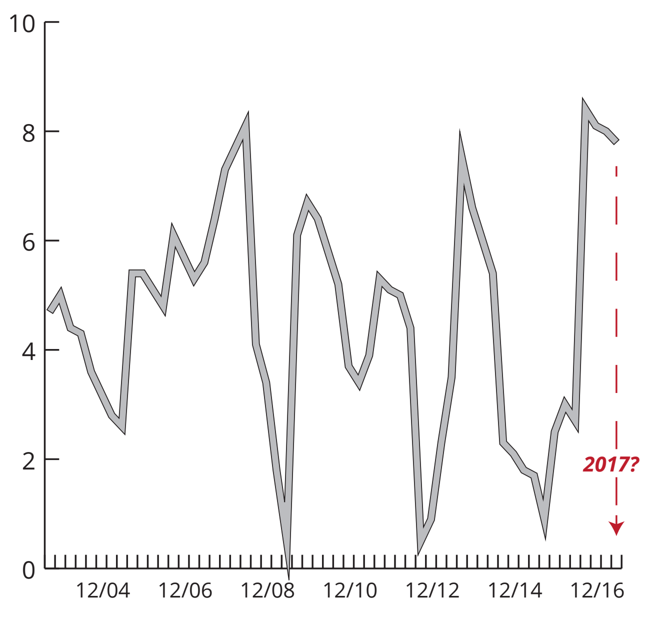
In this piece we update our take on the state of property sector inventories and outlook for activity in the sector during the coming year. Yearend data for 2016 shows that overall Beijing made solid progress with property sector destocking during 2016, but it was regionally unbalanced and fueled by rapid growth to mortgage credit. As described below, major policy goals for the coming year should include redirecting new flows of credit and building activity to lower-tier regions that account for a majority of sector volumes.

Earlier this week in **China Macro Monday** (2/13) we posed the question of whether property shares have gotten off to a bit of a false start in 2017. Our answer remains a qualified 'yes', and we see the risk of a retreat once the full package of transaction, price and cost data for January is released. As described below, this has is all happening in the backdrop to a policy stance that we are calling a "non-deflationary contraction", whereby policymakers attempt to prevent land and property price bubbles from deflating as they try to shift activity to suburban areas of major cities. We expect the release of widely followed monthly property sector data series to indicate that it will be difficult for Beijing to pull this off, while at the same time maintaining the current pace of destocking. Beijing's strategy should include tight controls on land supply in core areas of major cities, while increasing the supply of development land in surrounding areas, which could bode well for new housing starts in H2 of this year.

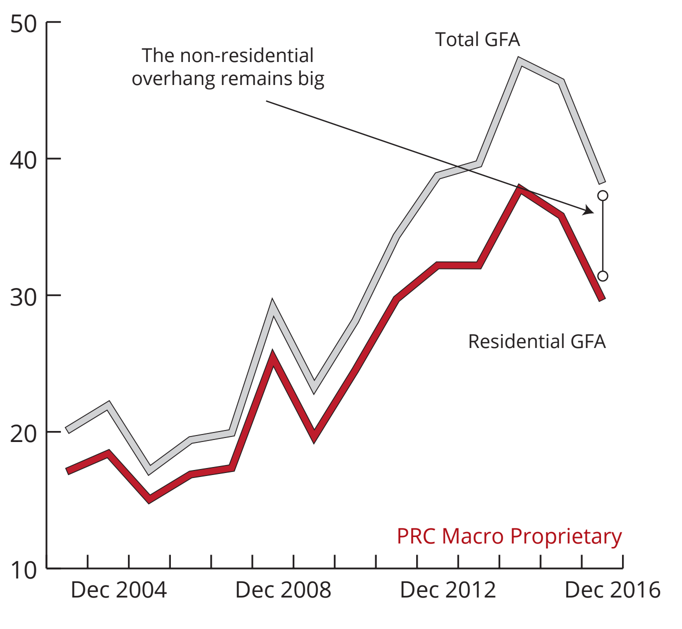
Tighter control on land supply in prime locations is supposed to give markets the perception of a supply shortage, thereby putting a price floor beneath property prices in higher tier cities. This is tantamount to the application of Beijing's industrial supply side reforms to the property sector. Increasing the supply of development land in surrounding, less desirable areas serves a political purpose (in addition to boosting local government fiscal income), which is to lower MoM increases to land auction prices, a target that Beijing has assigned to officials in top-tier cities. In the interim, however, accelerating construction activity associated with the broader urbanization agenda will be necessary to prevent a slowdown to growth, in part because the cyclical contribution of the real estate sector to growth should fall significantly this year.

If we think about the optionality implied in the importance of the property sector to macro and financial sector stability (both key goals this year),

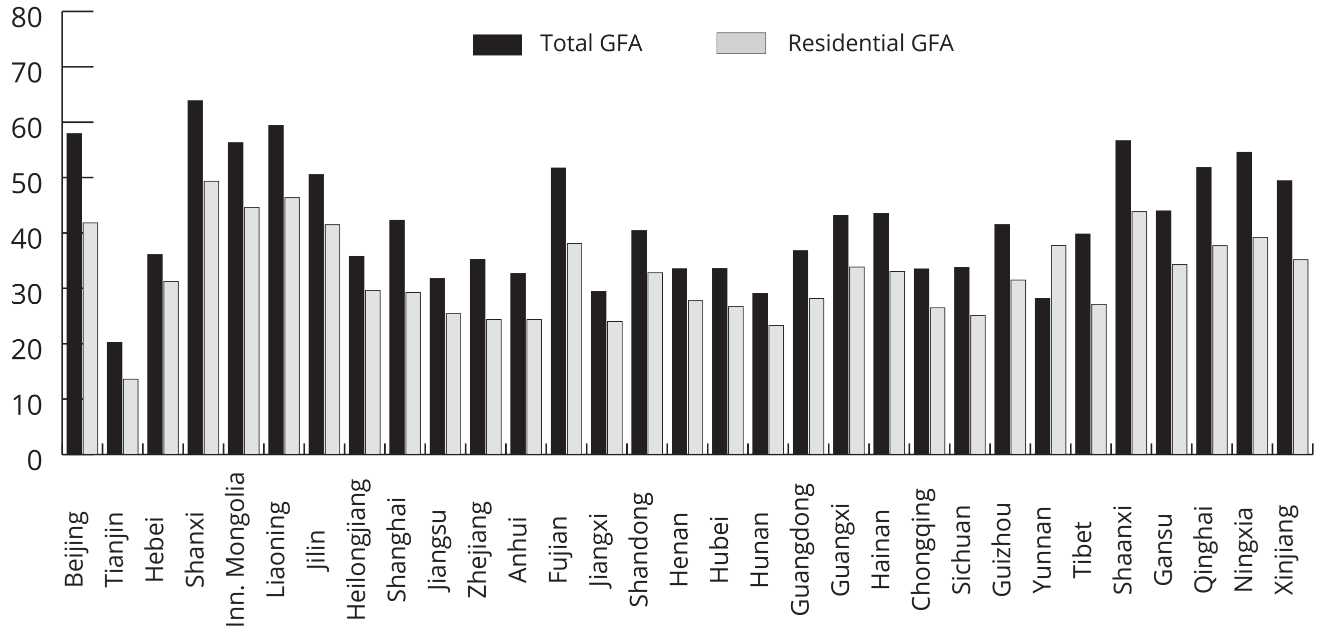
Real Estate - Direct Contribution Share to GDP Growth
quarterly data / percentage



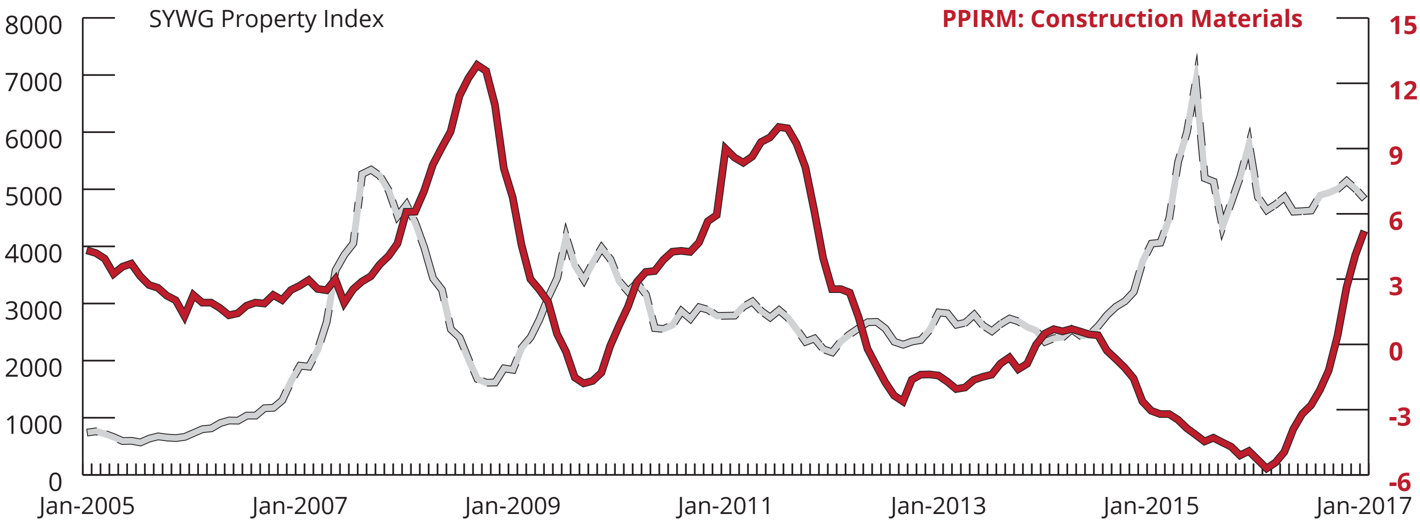
Estimated National Property Inventories
months sales



Months Sales Outstanding - Total Commercial Real Estate - by Province
months / 2016 yearend data



Developer Shares Underperform Under Reflationary Pressure
SYWG Property Index / YoY %



the RMB and money supply in general is a call on property, and credit is a call on the future value of property. Derivative to all of this is fiscal solvency, and total land transfer payments were down in 2016, but still exceeded RMB 3.5 trillion. In other words, property is still to China what oil is to petro states. A key difference, however, is that Beijing maintains a monopoly on the supply of land resources, as well as control over national credit taps. Questions remain about how far China can go with deleveraging, and the property sector remains an important constraint.

Achievements in Destocking in 2016

Despite waning momemtum in Q4 as a result of purchasing restrictions in top-tier markets, total property sector inventories at the national level came down by about 17% in 2016. For the residential property sector, our updated estimates show that the backlog of unsold properties fell by almost 7 months equivalent sales last year. However, as noted in our **Q3 Property Inventory Update** (September 29), this process was highly unbalanced, as relatively more advanced regions of the country were able to destock faster as a result of better access to mortgage credit. The data does not indicate that slowing credit growth in top-tier regions in Q4 resulted in improved availability of housing credit in lower-tier regions.

As indicated below, total property sector lending was up by 27% in 2016, led by an RMB 5 trillion increase (+35%) to individual mortgages (RMB 19.1 trillion outstanding). Lending to developers rose by just 8% to bring the outstanding stock of loans to RMB 7.1 trillion This data indicates that developers have been looking to either shadow bank credit or the bond market for credit. Bond market financing has dried up, but the January credit data indicates that developers have gone back to shadow banking channels for funds in a big way. This door, too, may soon closed if PBOC tightens up on shadow bank financing for developers in response to the January data.

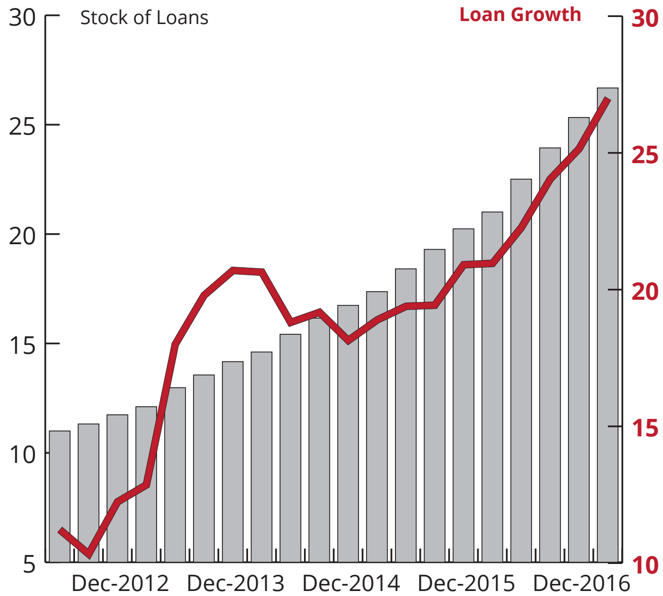
Overall, destocking dynamics continue to follow the core-periphery model that we have written about previously.

Property Policy Starting Point

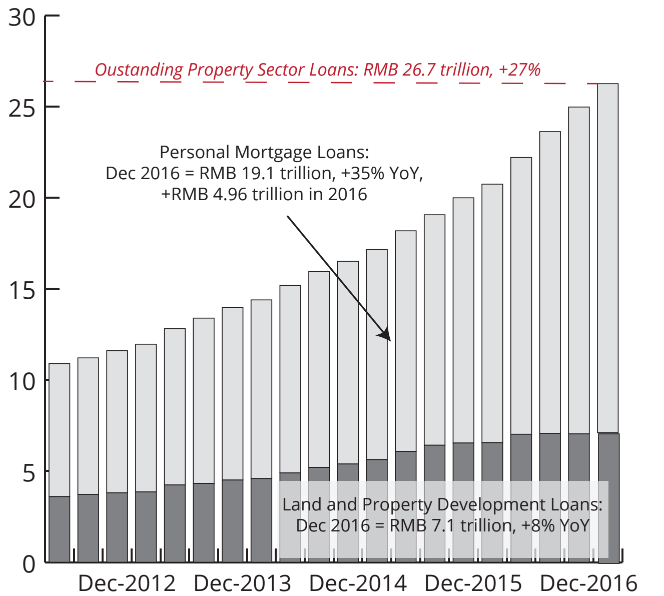
We expect more specifics for property sector policy at the NPC in March, but the CEWC in December provided some clear signals that will carry over (see: **CEWC Emphasizes Implementation and Deleveraging**, December 16).

• The CEWC explicitly linked destocking to urbanization. While differential policies will be applied to different tier cities, the policy focus will be on stimulating housing demand for lower tier cities.

Total Property Sector Bank Lending
RMB trillions / % YoY / quarterly data



Mortgage Lending Booms, Developers Look to Non-Banks
RMB trillions / quarterly data



- The Politburo still wants to advance the idea of attracting migrant workers to purchase homes from lower tier cities. That means two things: 1) building more roads and railways to connect lower tier cities with large cities, and improving the quality of public services in lower tier cities. This, along with broader regional development initiatives commits Beijing to maintaining the infrastructure boom in 2017; 2) put a floor on prices for higher-tier cities, to direct urbanization demand into lower-tier and newly constructed areas.

- Beijing doesn't want to deflate prices in top-tier markets, and wants to try to transfer some of this inflationary bias to areas outside major cities, that are supposed to serve as magnets for urbanization.

More recently, the property shares in China have responded favorably to what we are calling Beijing's attempt at a "non-deflationary contraction" in the property sector. The 'contraction' part should be temporary, as we expect policy makers to boost land supply in early H2 in areas peripheral to major cities that have experienced strong price growth in the past 18-months. We think the policy intent goes like this:

- As was the case with the stock market, Beijing will attempt to reduce land price volatility (especially increases) by reducing transaction volumes. This can be achieved with a version of the "national team", namely big SOE borrowers who have the balance sheets to buy a reduced supply of land resources in prime areas at premium prices.

- At the same time, the standing policy for residential property prices is that Beijing does not want to see MoM price increases this year. Land prices lead final property prices, so if Beijing can keep land prices up, then property prices will - in theory - fall less than they otherwise might given the range of credit and purchasing restrictions in top-tier cities.

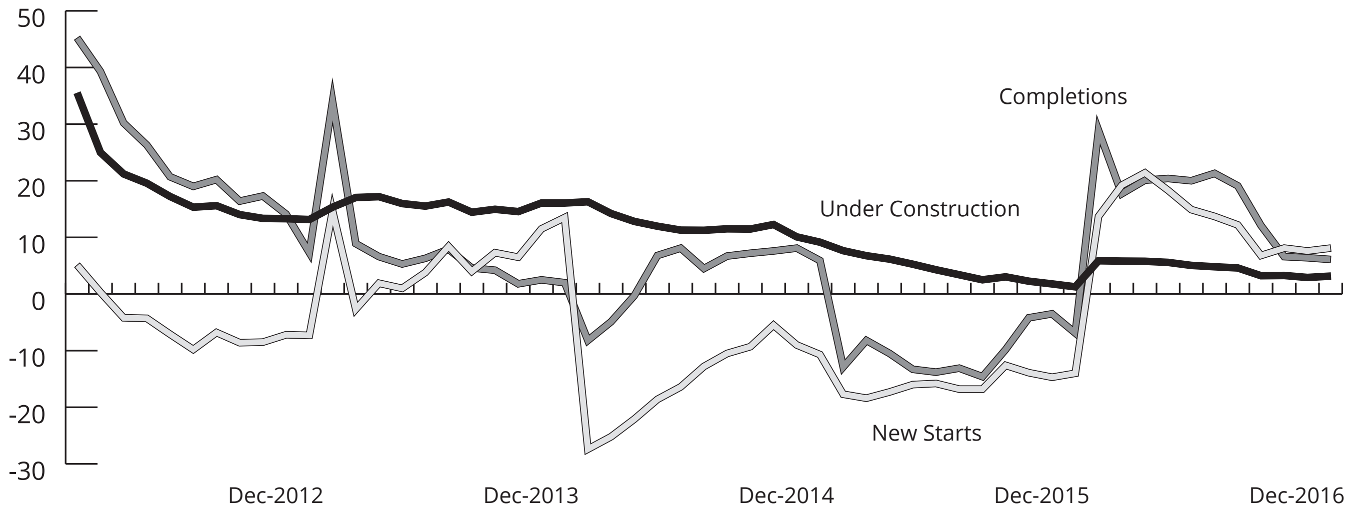
- Later in 2017, as Beijing redoubles its urbanization agenda (which the CEWC in December indicated would include inter-city transport networks and regional city cluster initiatives), it will have to release more land resources and targeted credit resources for the build out.

Developers Feeling the Pinch

Despite the continuing importance of the property sector to growth and overall financial stability, 2017 should still be a challenging year for developers. On one hand the current policy stance should be a drag on growth in H1. We can see a rationale on the other hand, however, whereby Beijing is tightening access to external funding in order to force developers to rely on internal financing, and thus shorten their sales cycles. In theory, this could be positive for destocking. Under the current policy mix, which should include the rationing of mortgage volumes, this will be difficult to pull off in practice, especially in lower tier cities.

On the supply side of the equation, continuing efforts to reduce NBF leverage amounts to tightening for

YoY Property Sector Activity Growth
YTD YoY % / Construction Floor Area



developers borrowing via shadow banks (WMPs, private placement bonds, etc). As noted in **Low Risk of Rate Hikes from Record Credit Growth** (February 14), we think more administrative tightening on shadow bank lending is likely after a record TSF number for January, which could lead to regulatory overshooting through administrative tightening.

Regulatory focus will likely be centered on cutting off banks' off-balance sheet funding for trusts and other NBFs, which have been used to finance LGFVs and property developers. Unlike LGFVs, who can be backstopped by local governments and can access bond market and PPP funds, property developers may well be at risk of losing access to external funding. Regulators have already moved to ban developers from using bond proceeds, banks loans, and PE funds to finance land purchases, and we believe the ban will soon be expanded to trust companies and "private placements" in equity markets.

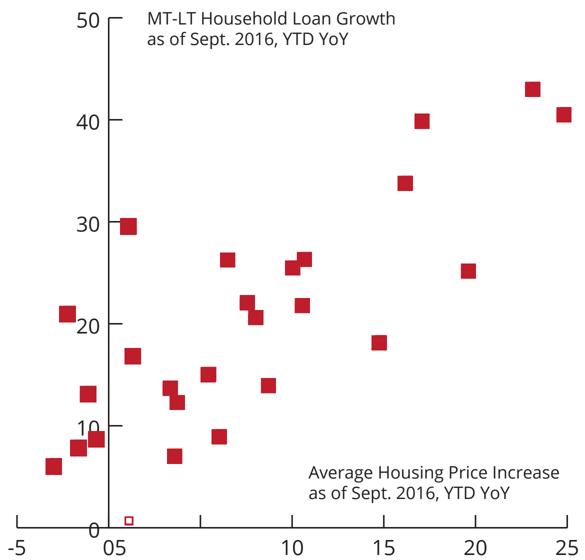
Bond market data for January indicates that total new issuance for the sector came in at just RMB 13.3 billion in January, a YoY decline of 92%.

Based on the lagged effect of previous year land sales, not to mention the expectation that land supply in H1 in suburban areas of core urban areas otherwise subject to controls, new starts in H2 could, however, accelerate to offset weakness in H1.

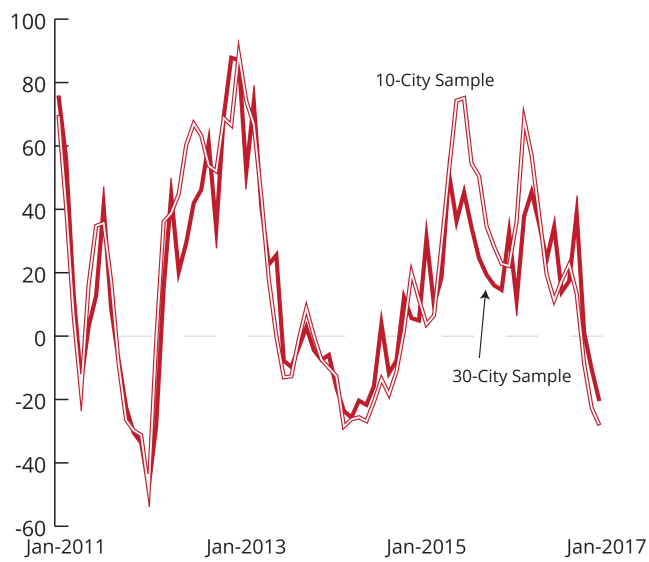
We also note that as depicted above, property shares have typically not performed well during reflationary episodes because land and construction materials and labor costs become more expensive. Here we looks at input prices for the construction sector, which have tracked closely with the recovery to PPI. In the context of softening household demand, developers are likely to margin compression from increased building costs and higher financing carrying costs of higher cost land resources. Here, too, however, we expect construction related PPI measures to peak at about the same time as industrial PPI, implying that sector performance in H2 could improve.

Perhaps more important to our belief that the recent rally in property sector shares could be short-lived is the result of clear signals from the demand side of the equation. For example, monthly sales volume and price series for January are not out yet, but aggregating higher frequency data for 10 and 30-city samples, floor area sales were off by 30% YoY in January, and 16% YoY so far in February. Last week numerous cities announced that they would reduce the permissible discount on mortgage loans (essentially a rate hike of an estimated average of 40 bps), and this follows "window guidance" from Beijing for property sector credit that should function as a monthly quota system. It is rumored, but not yet confirmed, that some banks have agreed to suspend new mortgage lending through March.

Household Leverage Differentiates Property Price Trends
provincial data



Transaction Growth Reaching Cyclical Trough?
Traded Property Area (10K sqm) YoY % / exponential smoothing



As expected, the credit data this week to showed that whereas during previous months property sector and mortgage loans accounted for 70% or more of new RMB loans, for January this proportion flip-flopped, with corporate loans accounting for 70% of the total. The monthly mortgage lending figure (RMB 752 billion) was still a record in absolute terms, but incremental tightening for property related credit continues. Absent off-setting demand side policy support, the current policy stance is negative for destocking.

For this reason, we expect the NPC in March to provide more specific targets for third and fourth-tier urbanization and/or destocking. As noted previously, and as one would expect, there has been a clear correlation between regional mortgage credit growth, price increases and destocking. This also correlates with per capita GDP, a proxy for relative regional tiering.