


China: A temporary blip or heading towards Japanification?

Q3 2023

Summary

- **1H 2023 (including July):**
  - **EM fixed income outperformed:** LC bonds and Sovereign HY outperforming IG bonds.
  - **Global inflation declined as expected**, due to lower manufactured prices.
  - Several divergences/**contradictions** to be resolved:
    - China GDP growth improved. Fiscal stimulus likely after poor Q2. Yet, Chinese stocks underperforming, holding back EM stocks.
    - Manufacturing recession vs. service sector boom.
    - Real yields high, liquidity tightening, the largest US bank collapses in history, but US stocks close to all-time highs (AI mania).
  - **Larger than expected US fiscal stimulus and tight labour markets** the most likely causes for the resilience.

- **2H 2023 Outlook:**
  - **EM fundamentals improving:**
    - GDP growth better than expected, or higher than 2022, across all regions (ex- ME/Africa).
    - Several EM economies implementing reforms: India, Indonesia, Brazil, and Turkey
    - Several Frontier economies reforming too: Angola, Nigeria, Egypt, Ghana
    - Valuations and technicals still favourable across EM equities and debt.
  - **Long end of the yield curve likely to be under pressure, in the absence of a strong slowdown:**
    - Large US fiscal deficit (8.6% of GDP last 12-months).
    - Outstanding T-bills approaching top of range optimal mix (25%).
    - Bank of Japan normalising yield curve control.
  - **Goldilocks now a consensus. Where can it be wrong?**
    - Tight lending conditions persist on the banking sector. Manufacturing PMI's soft, Service PMI's declining. Labour market softening.
    - US stocks sentiment and positioning over-extended.
    - Oil/Food prices rising again.

China: Searching for a new development model

Decade	% Urban Population (first year)	Real GDP Growth (CAGR YoY)	Gross Capital Formation (% GDP)	Consumption expenditure (% GDP)	Net Exports (% GDP)	CPI Inflation (CAGR YoY)	Average Current Account (% GDP)
1989-1990	19	9.7%	35.6	65.0	-0.6	7.5%	-0.5%
1990-1999	26	10.0%	37.3	60.4	2.1	7.5%	1.7%
2000-2009	36	10.3%	39.5	55.8	4.5	1.8%	5.0%
2010-2019	49	7.7%	44.8	52.9	2.3	2.6%	1.9%
2020-2029	64	< 5.0%	< 40	> 60	-	< 3.0%	-

Source: Haver Analytics, OWID, World Bank, Ashmore

China real estate – a multi-stage crisis

Ashmore

Stage 1 – Regulatory and Financial Tightening (from mid 2020)

- "Three Red Lines", tightening of credit and "politicization" of the sector through Common Prosperity theme result in tighter liquidity
- Market view initially was that tightening credit rules appeared sensible and likely to result in better credit fundamentals in the long run
- Property sales increased in H1 2021 as developers offered discounts and deleveraging efforts looked to be on track

Stage 2 – Repricing of risk following publication of H1 results and first defaults (from August 2021)

- H1 2021 reporting season for the sector brought a number of surprises, especially in regard to ballooning trade payables at Evergrande
- Government prioritises timely delivery of pre-sold units and repayment of wealth management products to maintain social stability
- Developer's cash reserves become trapped by revised bank escrow rules, further exacerbating liquidity and payment issues
- Q4 2021 sees a large wave of defaults among 14 issuers covering $44bn of nominal offshore bonds (of which Evergrande is almost 50%)

Stage 3 – Covid lockdowns intensify and construction / sales slow (Q1 - Q3 2022)

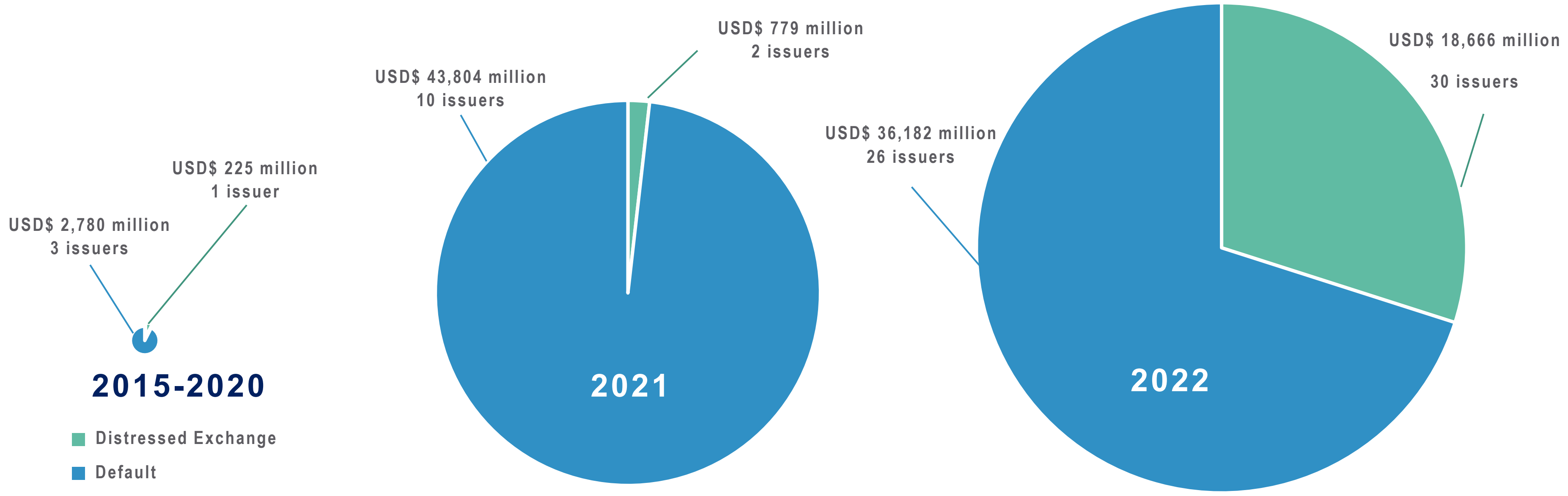
- New sales decline at the start of 2022 as investors mobility is reduced due to severe lockdowns. Run-rate sales across the sector are -50%, with distressed operators seeing sales -70%+ year-on-year
- Sector-wide lack of liquidity means, despite developer efforts, the stream of defaults continues: 40 further companies enter default in 2022
- Social unrest briefly manifests itself in a mortgage repayment boycott, which flares up across 75-80 cities with unfinished projects

Stage 4 – Policy Relaxation post Chinese Communist Party 20th Congress

- Re-appointment of Xi Jinping as ruler of Communist party for a third mandate and the composition of the Standing Committee brought initial market disappointment
- With hindsight, this proved to be the turning point with supportive policy initiatives following the congress. Key measures included: three arrows policy to recapitalize stressed developers, lowering of mortgage rates, access to USD liquidity backed by onshore security
- Relaxation of Covid-related restrictions and reopening of the economy triggers massive rally in Chinese assets
- In Q1 2023 downward pressure on property prices remained, yet sales have started to pick up, especially in Tier 1 cities. Market recovery is not evenly spread with large differences remaining in sales numbers of developers of different credit quality.

China real estate – defaults over time

Significant acceleration in the number of defaults in 2021 and 2022, in contrast with previous years



2015-2020	
Issuer	**Market Cap of Default (USD$ mn)**
KAISA Group	1,950
Tahoe Group	530
Wuzhou International	300
Yida China	225

2021	
Issuer	**Market Cap of Default (USD$ mn)**
Evergrande	19,236
KAISA Group	10,474
Fantasia	3,276
China Fortune	2,890
China Aoyuan	2,385

2022	
Issuer	**Market Cap of Default (USD$ mn)**
SUNAC	7,762
Shimao	5,720
Yuzhou	4,854
Guangzhou	4,360
CIFI Group	3,680

Source: Ashmore December 2022

Government announcements for Covid relaxation

Ashmore

Following a disappointing CCP Congress, there has been a change of direction immediately afterwards, with numerous positive announcements since then, showing that the new Government is serious about addressing the problems

Announcement from PBoC and CBIRC – 16-point directive aimed at supporting the property market:

- Stabilises access to new financing via construction loans for developers enabling them to finish existing projects
- Supports request for "reasonable extension" of existing loans by 1 year for maturities in the next 6 months without reclassification
- Bank staff will not need to be responsible for NPLs as long as they have exercised due diligence
- Temporary relief in regulatory measures for bank capital, when banks roll exposures to developers in distress

Announcement by NAFMII – the "Three Arrows" policy aimed at supporting access to new capital for developers

- **First Arrow (loans)**: in addition to the 6 state-owned banks who were asked to provide CNY 600bn financing, joint-stock banks are also asked to provide CNY 400bn, adding to a total of CNY 1trn. This is on top of CDB's CNY 200bn real estate fund for home delivery
- **Second Arrow (bonds)**: plans to support CNY 250bn of bond financing of private property developers with PBOC backstopping the facility. Some of the capital will be used for direct purchases of distressed bonds in the market
- **Third Arrow (equity)**: this is related to SOEs acquiring a stake in POEs. This is something for the medium term, as first valuations need to stabilize before M&A activity can resume.

National Health Commission – 20 point list of Covid control relaxation measures

- Two rounds of Covid relaxation measures announced on November 11th and December 7th, followed by downgrade of Covid risk to Level 1 from Level 2
- Removal of centralized quarantine and contact tracing in early January followed by opening up of international travel without quarantine
- Despite the surge in infections and growing death toll, Chinese government seems intent to stay the course with the planed reopening

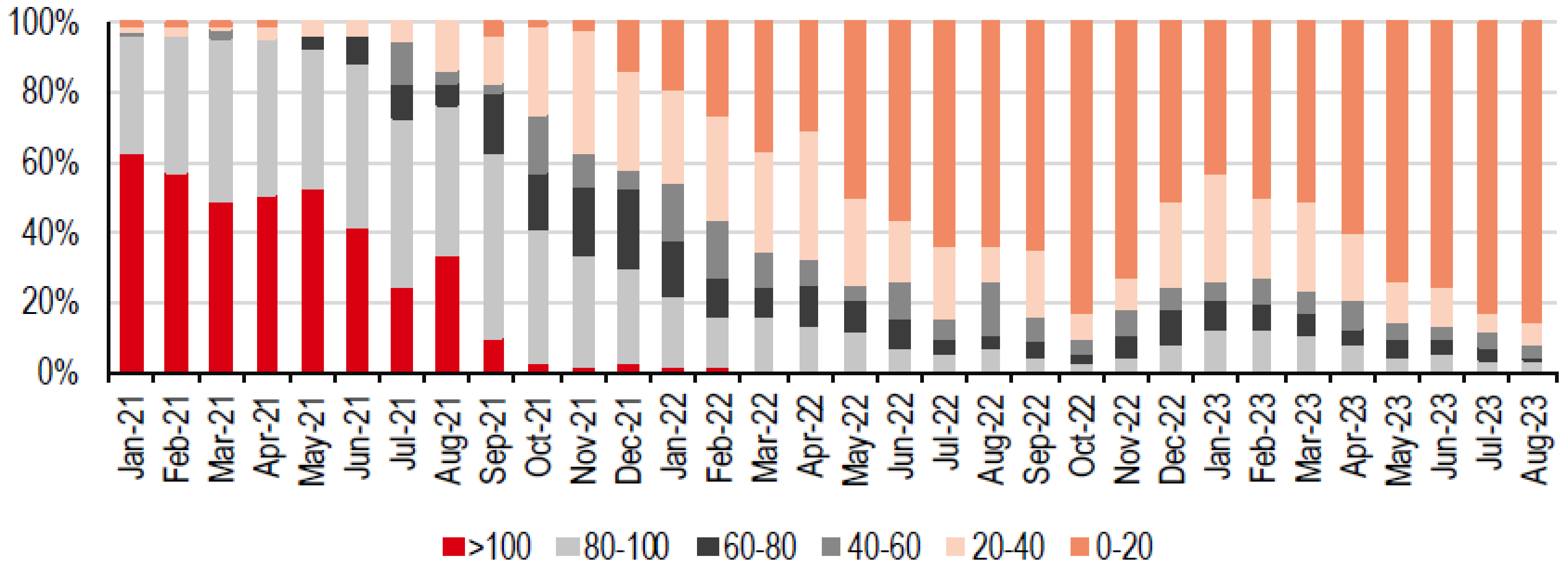
Source: Ashmore, Dec 2022

China real estate – Have prices bottomed?

Strong signs of capitulation in the Chinese property market

- 2021 defaults were concentrated among the more highly levered names, typically already in breach of the infamous 3RL policy
- 2022 defaults spread gradually across the sector, engulfing majority of issuers
- At end of October 2022 over 80% of the Chinese USD property bonds were trading at prices below 20c
- Bond prices started to recover from November 2022, yet after some strong gains in early 2023, the lack of strong central bank policy to influence the consumer, worsened sentiment
- Significant central government driven stimulus to consumer and to the property sector is beginning and expected to continue over the next 6 to 12 months

China Property USD HY bonds – Evolution of prices

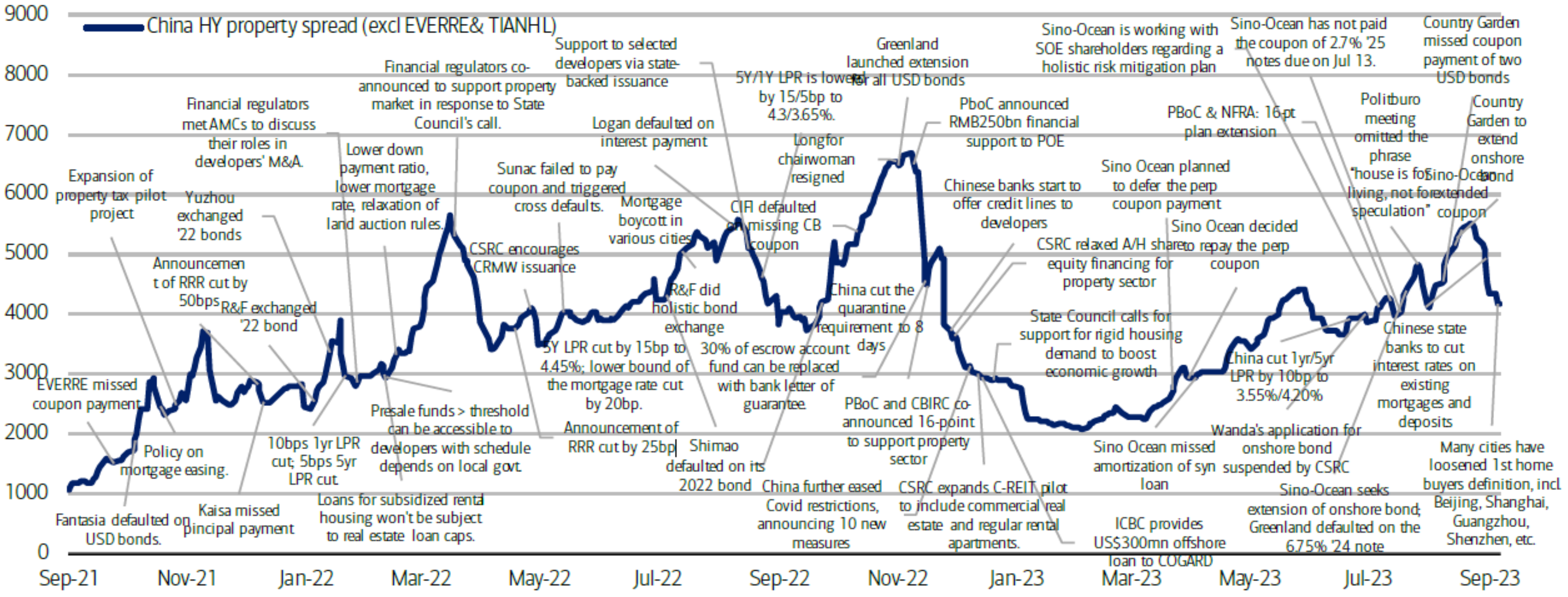


Source: HSBC, Aug 2023

China real estate – Has the tide finally turned?

The recovery started in November 2022 with the reopening of the economy but fizzled out by end of Q2 2023

- ❑ Defaults have peaked in second half of 2022 from outright suspension of payments to various forms of distressed bond exchanges
  - A total of USD 54.8 bn of China HY property bonds defaulted during the year
  - 56 issuers have defaulted in 2022, representing 65.9% of all China HY property bonds by volume
- ❑ For 2023, the market remains focused on:
  - Improved levels of economic activity post economic reopening saw a strong bounce for investor sentiment. Some developers bond prices doubled or even tripled in value during Q1
  - The pace of economic activity was not sustained in Q2 and investor's confidence fizzled very quickly with bond revisiting previous lows during the less liquid months of the summer.
  - Weakness in property sales and fear of new large defaults forced the government back into action



Source: Bank of America, Sep 2023

Concerted Government action after a summer of indecision

Ashmore

China's slowdown is cyclical rather than structural. Policymakers can jumpstart growth with coordinated fiscal, monetary, and property stimulus if decisive actions are taken.

September 2023 policy announcements:

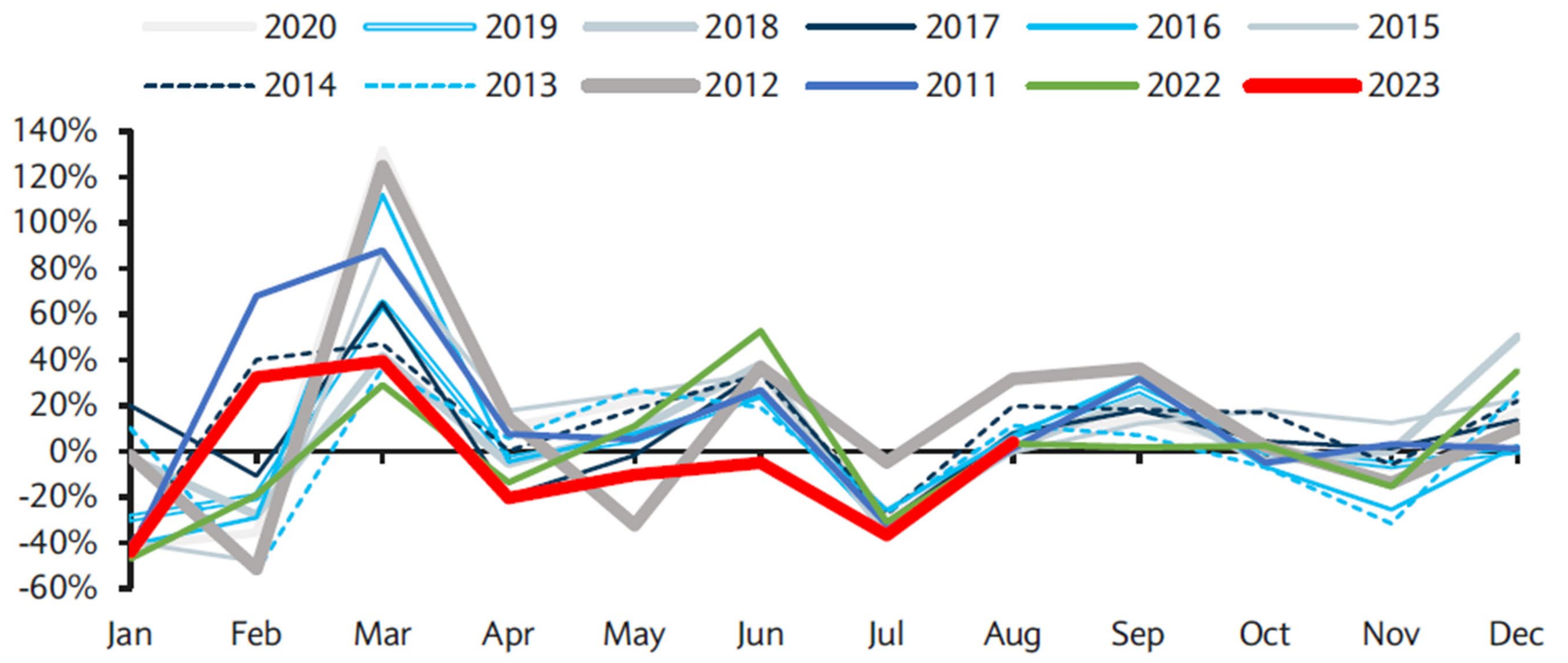
Policy change	Old	New	Impact
Downpayment ratio	Cities with purchase restrictions: 30% for first homes and 40-80% for second homes	Minimum down payment for first-home reduced to 20%, and to 30% for second-home buyers for all cities, effective 25 September 2023	Standardizes downpayment ratios nationwide
Mortgage rate	Allow cities where home sales prices have declined for three consecutive months (both m/m and y/y) to reduce, maintain, or cancel the lower limit of first home mortgage rate; lower limit of mortgage rate for second home to LPR+60bp	For existing mortgages (signed before 31-Aug-23): lower limit of mortgage rate for second home adjusted to related LPR+20 bps, lower limit of mortgage rate for first home remain at related LPR-20 bps (starting from 25-Sep-23)	Lower the mortgage rates for existing home buyers. According to Xinhuanet, about 40mn households will become eligible to negotiate a lower mortgage rates, with an average decline of 0.8pp after the mortgage rate adjustment
Relaxing the criteria to obtain first-home mortgage loan: "Recognizing the house ownership records, not the mortgage records" "认房不认贷"	Tier 1 cities and some tier 2 cities implemented stricter criteria for first-home mortgage loans, where buyers with past mortgage records were considered as second-home buyers even though they currently do not own a home	All four tier 1 cities and some tier 2 cities relaxed mortgage rules to allow first-home buyers to benefit from preferential mortgage rates and downpayment ratio, regardless of their previous mortgage records	Should increase housing upgrading and replacement demand, with tier 1 cities benefiting most from preferential mortgage policy treatment due to a larger reduction in downpayment ratio
Deposit rate		Coordinated cut in deposit rates for the third time in a year, 1y annualized rate for deposits reduced 10bp, to 1.55%, and 5yr rate reduced 25bp, to 2.25%, effective 1 September 2023	Designed to reduce the pressure on banks' net interest margin following the mortgage rate cut

Source: Bloomberg, local media and Barclays Research

Cyclical rebound in property sales after summer lull

Ashmore

Property sales expected to rebound in September, but will momentum be maintained into the end of the year?



Source: Company data, Barclays Research