China's property market downturn is making investors nervous given concerns that the real estate market slump could have spillover effects for the banking sector. Although China’s property sector could be under pressure for some time, we think there are a few reasons the banking sector might sidestep wider economic turmoil.

This edition of *Global Insights* explores the causes behind China's property market slump and addresses contagion fears.
China’s property market downturn is making investors nervous (see Exhibit 1). Unnerved by last year’s regulatory crackdown, their risk tolerance has waned. In 2021, policymakers introduced regulations intended to restrict the build-up of leverage in China’s real estate sector. By the end of the year, the MSCI China Real Estate Index had declined 32.3%—the largest annual decline since the 1997-1998 Asian financial crisis. Since then, it has fallen an additional 30%, as the crisis has worsened. Investors worry that China’s real estate market slump could have spillover effects for the banking sector, posing a risk to the country’s economy for the remainder of 2022.

Exhibit 1: Declining Home Prices Could Keep Investors on the Sidelines

Given the size of China’s real estate market, investors are understandably skittish. First, according to China’s National Bureau of Statistics, real estate development investment stood at 14.8 trillion yuan in 2021—more than double the level in 2011. Second, China has a larger real estate market than other major countries. In fact, according to London-based real estate services company Savills, as of 2018 the combined value of commercial and residential real estate in China was already slightly greater than that of the US and surpassed that of other large nations like Japan, the UK, India, Germany, France and Brazil (see Exhibit 2). Finally, according to the National Bureau of Economic Research, the sector’s contribution to China’s gross domestic product could be as high as 29%—underscoring its importance as a potential growth engine.

China’s real estate downturn could also hurt local governments that rely on income from the sale of land-use rights (see Exhibit 3). Individuals in China cannot privately own land, but local governments can lease land to developers and collect fees. Unfortunately, a weak property market could weigh on municipalities, as they rely on the sale of land-use rights for about 40% of their revenue, according to data from E-House China Research and Development Institute. For the five-year period ending in 2020, income to local governments from the sale of land-use rights has more than doubled, to 8.4 trillion yuan.

Exhibit 3: An Overreliance on Income From Land-Use Rights Could Weigh on Local Governments

Many would-be home buyers are also feeling pressure, as indicated by the more than 20% drop in residential property sales (see Exhibit 4). Investors worry that sales could fall further as price declines in major cities set off a vicious cycle that: 1) weighs on confidence in the property sector, 2) depresses new home sales and 3) leads to even lower prices, before starting all over again.
Many Chinese citizens own multiple homes, which has been both a driver and result of rising prices. Notably, Statista reports that at the end of 2017 the majority of new home purchases were for either second or third residences (see Exhibit 13). According to the 2018 China Urban Household Wealth Health Report compiled by China Guangfa Bank and Southwestern University of Finance and Economics, housing accounted for 75% of urban household wealth in China, versus 28% and 41% in the US and Japan, respectively. It is no surprise, therefore, that confidence has tumbled to the third lowest reading on record amid the property market turmoil (see Exhibit 10).

Exhibit 4: Property Sales Have Plunged as the Crisis Has Deepened

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022

China’s property sector could remain under pressure for some time. In our Feb. 9 Global Insights, “Riding the Tiger: China’s Regulatory Crackdown,” we explored China’s crackdown on the real estate industry and its "three red lines" policy, which cut off access to capital markets for some of the larger real estate developers. Since then, some of the more indebted developers have defaulted on both local currency and US dollar-denominated bonds. In fact, the Bloomberg Asia ex-Japan USD Credit China HY Index—composed of 34% China property market bonds—has widened 794 basis points for the year to date (see Exhibit 12).

Developers, facing mounting losses and a lack of access to capital markets, have now also been forced to contend with homebuyers who are hesitant to provide deposits or advanced payments to fund future residential projects. Deposits and advanced payments, as a source of total development funds, have declined from a peak of 41.6% in December 2020 to 33.2% today (see Exhibit 5).

Exhibit 5: A Key Funding Source for China’s Real Estate Developers Has Recently Declined

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022

Some buyers are also refusing to pay their mortgages. Starting last month, reports of homeowners refusing to pay mortgages on unfinished or stalled properties increased. According to Bloomberg, a whopping 70% of Chinese homes are sold before construction, which means banks could be forced to bear the responsibility if homebuyers refuse to make mortgage payments. It’s easy to see why investors are worried. Importantly, a slowdown in the construction pipeline and reduced construction activity are fueling concerns that property sector weakness may be more severe than investors realize (see Exhibit 6).

Exhibit 6: China’s Construction Pipeline Activity Is Declining Sharply

Source: CEIC, Gavekal Dragonomics, Macrobond, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022

According to Bloomberg, bank exposure to outstanding mortgages and loans to developers stand at 52 trillion yuan (see Exhibit 7). Policymakers, worried that the growing crisis could further impact the broad economy, are considering an array of tools to stabilize the property market and reduce the risk to China’s banking system. Although details are sparse, officials have hinted at a real estate fund to help property developers complete unfinished projects. According to
Pantheon Macroeconomics, the fund could be scaled up to 300 billion yuan. However, given the size of outstanding mortgages and loans, it is unlikely that the fund could bail out the property and banking sectors. That said, we believe intervention from Beijing would restore investor confidence.

Exhibit 7: Chinese Banks Exposed to 52 Trillion Yuan of Outstanding Mortgages and Loans to Developers

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022

Ultimately, we think that there are a few reasons the banking sector might sidestep wider economic turmoil. First, China’s banks are well capitalized. In the first quarter of 2022, the Tier 1 capital adequacy ratio of Chinese commercial banks was 12.3% (see Exhibit 8); the Peoples Bank of China (PBOC) defines levels below 7.5% as failing the stress test.

Exhibit 8: China’s Banks Appear to Be Well Capitalized Versus History

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of March 31, 2022

Second, although some buyers have threatened to stop making payments, impacted mortgages are only a small portion of total bank assets. According to data from Absolute Strategy Research, the 16 banks that reported overdue mortgages make up only about 0.01% of outstanding mortgages.

Finally, China’s nonperforming loan ratio has recently been stable and is lower than in prior years, at 1.7% (see Exhibit 9). In fact, according to Alpine Marco, an independent global macro investment firm, China’s residential mortgages have a delinquency rate of only 0.3%.

Exhibit 9: Nonperforming Loans Look Manageable Versus History

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of March 31, 2022

Investment Implications

On the surface, China’s property market faces multiple headwinds from declining home sales and construction activity and weaker consumer confidence coming out of pandemic lockdowns. But looking at the market more broadly, we don’t think that its property sector issues are contagious.

First, officials have hinted at a real estate fund to help property developers complete unfinished projects. The proposed 300 billion yuan fund could break the vicious cycle that has weighed on confidence and dampened sales. Second, banks’ exposure to the property sector is limited: Alpine Marco suggests that even the most pessimistic estimate would put total loans impacted at less than 1% of total commercial bank assets. Finally, China’s nonperforming loan ratio has recently been stable and, at 1.7%, is relatively low on a historical basis.

However, since news of the mortgage boycott surfaced in July, banks have traded down amid growing fears of financial contagion. In fact, since the end of the second quarter, the MSCI China Banks Index has underperformed the MSCI World Banks Index by nearly 20% (see Exhibit 12). We think that weakness in China’s banks may be overdone. According to Morgan Stanley & Co.’s China equity analysts, the earnings impact on Chinese banks from property-related risks should amount to less than 5%, on average, over a period of two to three years. While we are mindful that the resolution of property-specific issues may take time, we believe that Chinese banks may offer an interesting opportunity.
Charts You Can't Miss

Exhibit 10: Consumer Confidence Nears Lowest Level on Record

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022

Exhibit 11: China’s Real Estate Bonds Are Key Drivers of Asia High Yield Underperformance

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Aug. 2, 2022

Exhibit 12: Chinese Lender Underperformance Could Be Short-Lived

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Aug. 3, 2022

Exhibit 13: Many Chinese Citizens Own Multiple Homes

Source: Statista, Morgan Stanley Wealth Management Global Investment Office as of November 2018
Current Readings From Our Quantitative Framework

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Ongoing Development Spotlight

Over 15 years ago, the US housing market reached peak exuberance, and the resulting correction led to the largest economic contraction since the Great Depression. Similarly, the last decade has seen home prices in Canada, Australia, Norway, New Zealand and Sweden rise to historic levels relative to rents and incomes. While elevated prices alone do not guarantee collapse, investors should look out for spikes in supply versus demand. A scenario where tighter monetary policy leads to higher rates and decreased demand for homes, while also increasing unemployment, could be a catalyst for a decline in global housing. While other markets are smaller than the US and do not have its derivatives scope, surging home prices in certain countries are a risk worth monitoring. –Brad Fulton

Exhibit 14: Home Prices Are Rising Faster Than Rents

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of June 30, 2022
commodity pricing risk, supply and demand risk, depletion risk and exploration risk.

Investing in commodities

Asset allocation and diversification

Yields

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

Glossary

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Risk Considerations

Investing in foreign markets entails greater risks than those normally associated with domestic markets, such as political, currency, economic and market risks. Investing in currency involves additional special risks such as credit, interest rate fluctuations, derivative investment risk, and domestic and foreign inflation rates, which can be volatile and may be less liquid than other securities and more sensitive to the effect of varied economic conditions. In addition, international investing entails greater risk, as well as greater potential rewards compared to U.S. investing. These risks include political and economic uncertainties of foreign countries as well as the risk of currency fluctuations. These risks are magnified in countries with emerging markets and frontier markets, since these countries may have relatively unstable governments and less established markets and economies. Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer. Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

Asset allocation and diversification do not assure a profit or protect against loss in declining financial markets.

Investing in commodities entails significant risks. Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention. Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies. Technology stocks may be especially volatile. Risks applicable to companies in the energy and natural resources sectors include commodity pricing risk, supply and demand risk, depletion risk and exploration risk. Health care sector stocks are subject to government
regulation, as well as government approval of products and services, which can significantly impact price and availability, and which can also be significantly affected by rapid obsolescence and patent expirations.

The returns on a portfolio consisting primarily of environmental, social, and governance-aware investments (ESG) may be lower or higher than a portfolio that is more diversified or where decisions are based solely on investment considerations. Because ESG criteria exclude some investments, investors may not be able to take advantage of the same opportunities or market trends as investors that do not use such criteria. The companies identified and investment examples are for illustrative purposes only and should not be deemed a recommendation to purchase, hold or sell any securities or investment products. They are intended to demonstrate the approaches taken by managers who focus on ESG criteria in their investment strategy. There can be no guarantee that a client’s account will be managed as described herein.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Investors should consult with their tax advisor before implementing such a strategy.

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