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# Property Risks Bigger in the East

## Executive Summary

➢ **China**: Barring the Europe debt crisis, downside risks to growth pertains largely to the domestic property sector. As long as the authorities' response is timely to developments in this sector, growth should not slow drastically (once again barring external events and developments). In light of that, Chinese equities do offer value at the moment and it is worth a consideration.

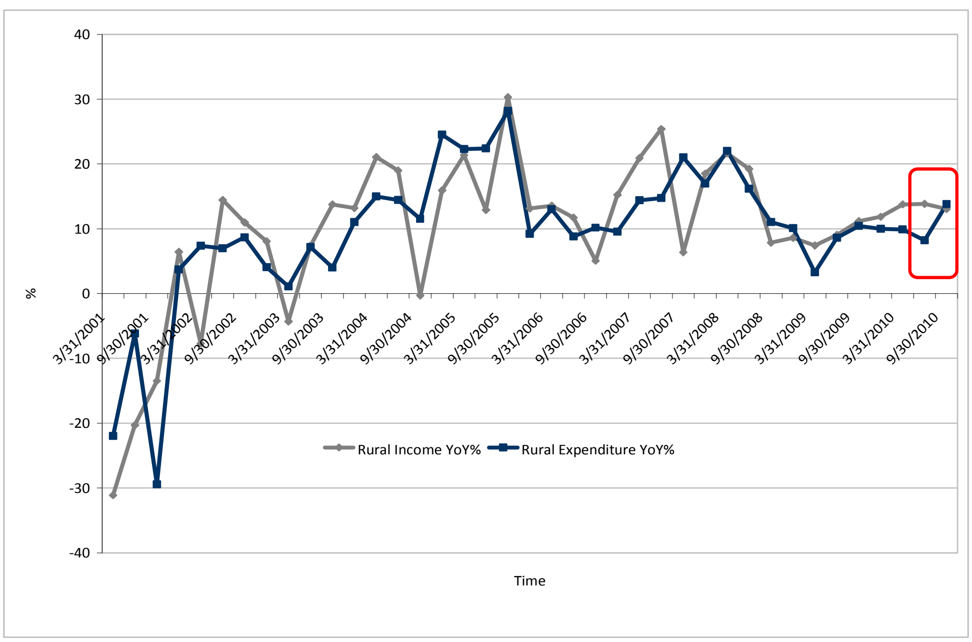
➢ **United States:** Other than the better than expected economic readings that have been grabbing news headlines, news relating to the property sector have also been encouraging. The positive momentum in the housing sector is likely to continue in the near term; driven by low mortgage rates and low housing prices. On the back of positive economic developments (and barring external risks), earnings yield on US equities is relatively attractive when compared against the yield on a 10 year treasury. Therefore, it is worth reconsidering having some tactical exposure to US equities.

### China: Hopeful – but still not the time

The Chinese economy expanded 8.9% y-o-y in Q4 11, just slightly lower than the 9.1% recorded in Q3 11. December data realized was also upbeat. Industrial production remained robust, growing 12.8% y-o-y in December against 12.4% in November. Meanwhile, retail sales growth was also better than expected. It accelerated to 18.1% y-o-y in December in nominal terms from 17.3% in November. A point to note on the latest retail sales reading is that the pick-up in sales may have been driven by seasonal factors such as Chinese New Year and year-end spending. Another point to note is that while retail sales have gained strength, urban household's spending growth slowed. As such, stronger retail spending could have been driven either by rural households or by government spending.

*China's December economic data has not been as weak as expected.*

**Figure 1: Stronger retail spending might be driven by rural households**




*Source: Bloomberg, as of Dec 2011.*



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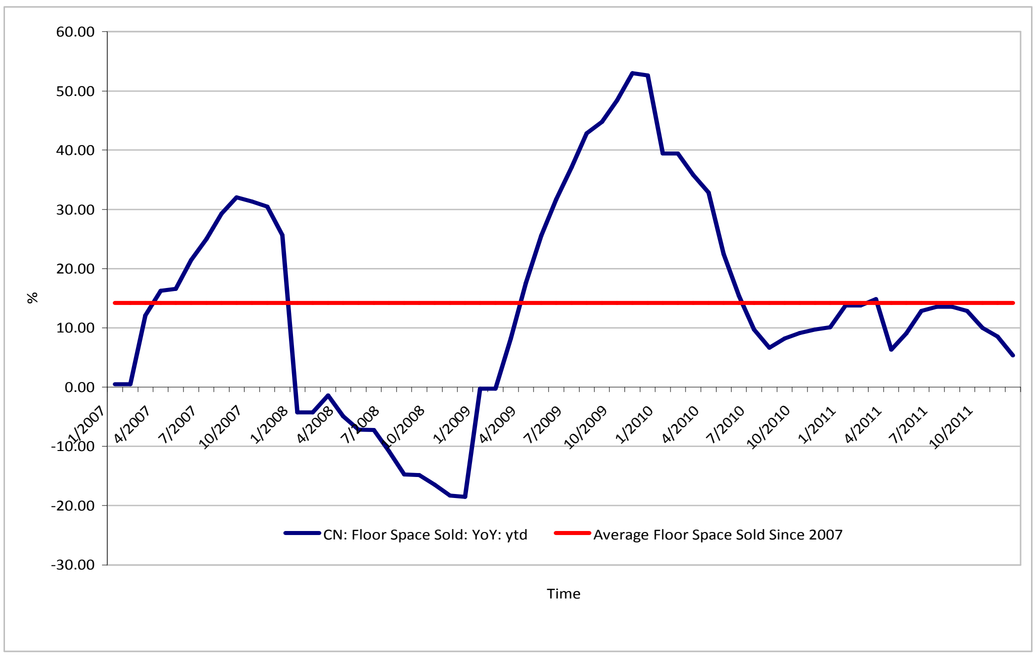
This positive trend continued in January as reflected in the HSBC/Markit flash PMI. The index ticked up slightly from December reading of 48.7 to 48.8 in January. No doubt that the increment is small and the level is still low, it nonetheless marks the second successive increase. In turn, this suggests that conditions in manufacturing are not contracting further. Reading into the components of the index also revealed that inflation is no longer a major concern. This is so as the reading for both input and output prices remained well below 50. Nevertheless, the January estimates should not be over relied upon. This is so as the data was collected ahead of the Chinese New Year holiday and therefore there might be some discrepancy. Even while that is the case, the latest reading is in line with the GDP and industrial production data; suggesting that economic activities are holding up and not deteriorating dramatically.

Once again, the above has reinforced that the economy is slowing but not in a drastic manner. Hence, there are insufficient reasons to expect a quick move to further loosening. Indeed, PBOC has signaled that they are in no hurry to loosen in their latest effort to help banks respond to seasonal demand for cash and loans during Chinese New Year. They have chosen to suspend bill sales instead of reducing the reserve requirement ratio, contrary to general expectations.

*Recent data has reinforced that the economy is slowing but not in a dramatic manner. Hence, there are insufficient reasons to expect a quick move to further loosening.*

Nonetheless, while policymakers may not consider significant policy easing at the moment, things might change should the property sector slows drastically.

**Figure 2: Floor spaces sold in December 2011 below average**




*Source: Bloomberg, as of Dec 2011.*

*Property sector is a major area of concern. Floor space sold fell 5.4% y-o-y; following an average growth of 14.2% since 2007.*

The property sector is a major area of concern. Property investment hit a 24-month low of 27.9% y-o-y in December, compared to 33.2% in 2010. Residential investment is also lower relative to 2010. Full year investment in residential housing registered an increase of 30.2% from the same period the year before, down 2.6 percentage points from 2010. Floor space under construction fell 25% y-o-y in December, in turn suggesting that investment in this sector has much further to fall. Sales volume also continued to decline. Floor space sold fell 5.4% y-o-y; following an average growth of 14.2% since 2007. Like we have mentioned before, the reason why this sector is closely watched is because housing investments has been contributing significantly to the country's growth. A significant slowdown will be a drag on the Chinese economy.

Perhaps the winners amid this slowdown in the property sector are rental property owners. Demand for rental housing is likely to rise as people hold onto their property purchase while waiting for prices to bottom. In turn, this will cause rentals to increase in the meantime. Residential property rentals has risen by 2.9% in December from a year ago. This trend is set to continue.

On the whole, we continue to hold the view that the Chinese government stands ready to prop up the economy and recent actions have also shown their commitment in doing so. Nonetheless, for overall policy bias to shift dramatically from tightening to loosening remains unlikely in the near term. It will be conditional on more definite downside risks to growth.

Barring the Europe debt crisis, downside risks really pertains largely to the domestic property sector. As long as the authorities' respond timely to the developments in this area, growth should not slow too drastically (once again barring external events and developments). In light of that, Chinese equities do offer value at the moment and its worth a consideration. For more details, please refer to our Asset Class Update report.

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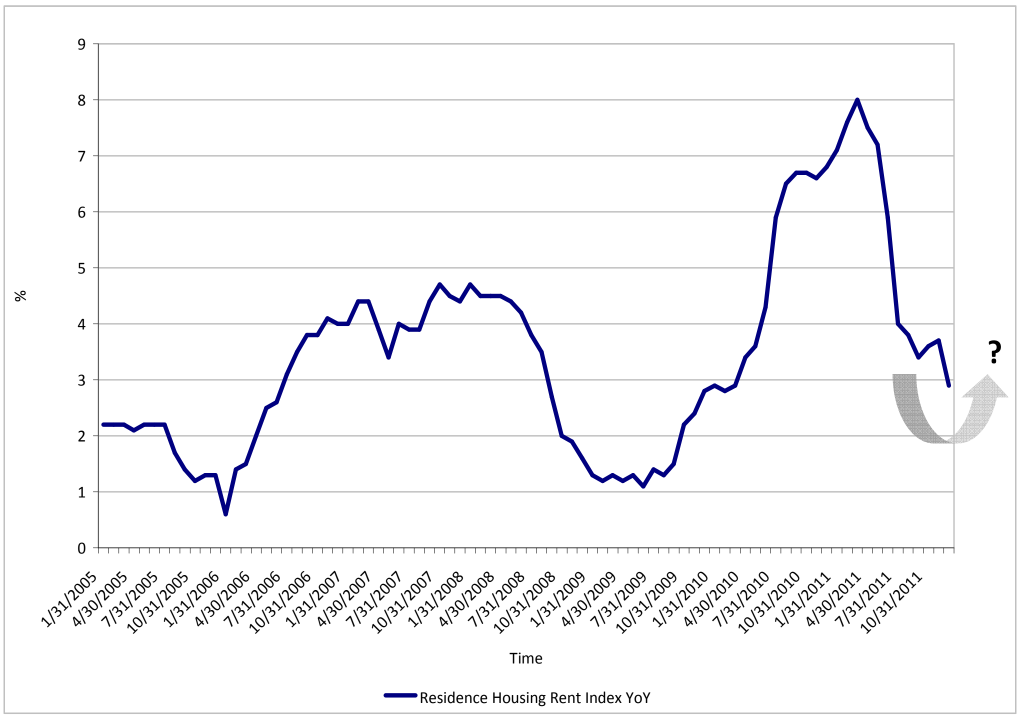
*Barring the Europe debt crisis, downside risks to growth pertains largely to the domestic property sector. As long as the authorities' response timely to the developments in this area, growth should technically not slow too drastically (once again barring external events and developments). In light of that, Chinese equities do offer value at the moment and its worth a consideration.*

**Figure 3: Residential property rentals set to rise**



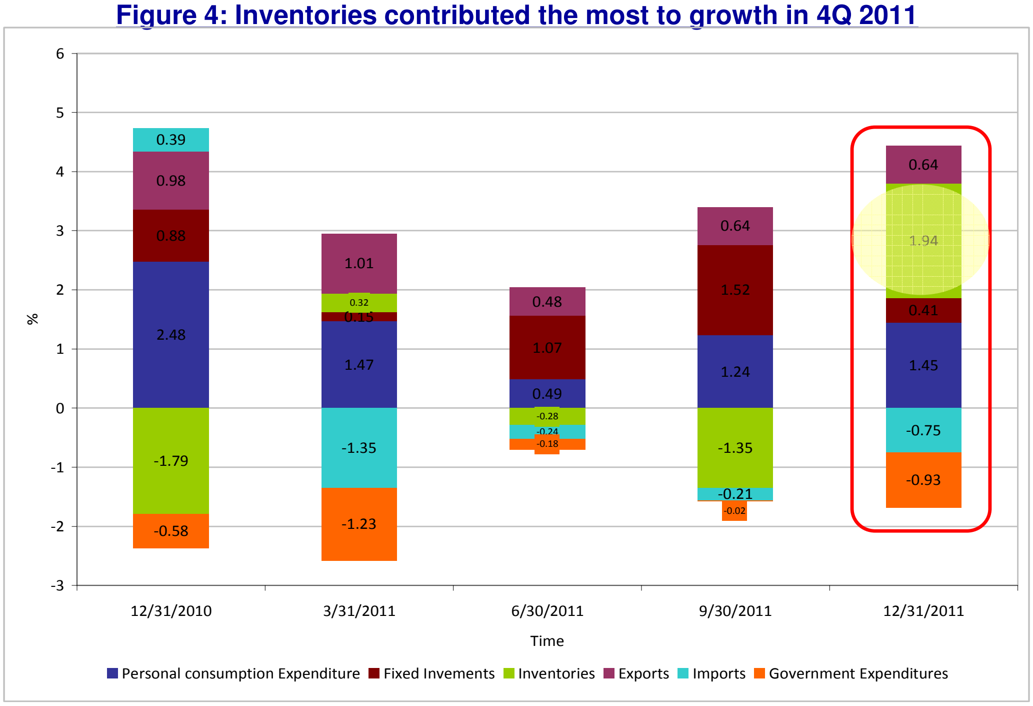

*Source: CEIC, as of Dec 2011.*

## United States:

News headlines have been pointing to better than expected economic readings in the United States for the last few months. Indeed, the manufacturing sector in the United States has performed better than the manufacturing sector in other major developing economies (China in particular). The Institute for Supply Management's (ISM) manufacturing survey moved up to 53.9, up from 52.7 — while new orders rose to 57.6 from 56.7. The service sector also continues to show signs of strength as the ISM Non-Manufacturing Index rose to 52.6 from the previous month's 52.0. Additionally, the employment components of both surveys improved, with the manufacturing side rising to the best level since June 2011. Meanwhile, retail sales have held up better than expected, even though year-end sales were a little softer than usual on the back of festive season spending.

Despite the better monthly economic readings, the US economy grew only at an annualized pace of 2.8% in the supposedly good fourth quarter; slightly below expectations of a 3% gain. While it is still better than third quarter's 1.8% growth rate, what is a concern moving forward is that strength in the latest GDP numbers was largely attributed to a rise in inventories as restocking took place. In other words, should inventories fall in Q1 2012, we are likely to see growth retrace in tandem. This is possibly going to be the case especially when a tight fiscal situation is unlikely to benefit growth significantly. Also, personal consumption is not likely to contribute significantly to growth as income growth has been coming down. Besides, in the latest reading, personal consumption contribution is already smaller than expectations (2% versus estimation of 2.4%). Indeed, Fed Chairman Ben Bernanke acknowledged that while there have been improvement in some areas, he does not think that US is ready to declare that it has entered a new and stronger phase of growth at the moment.

**Figure 4: Inventories contributed the most to growth in 4Q 2011**

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In view of the above, the good news is that the Federal Reserve has opted to keep the federal funds rate at near zero percent and anticipates that economic conditions are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014. The reference to 2014 was an extension of Fed's previous pledge to keep rates low till mid 2013.

**Housing sector**

We mentioned on several occasions last year that the housing sector remains an area to be watched as it is very much linked to the financial position of households. In turn, this affects individual's willingness to consume. There is interdependence between the two variables.

We are pleased that recent news relating to the property sector has mostly been encouraging. The NAHB index rose for the fourth consecutive month without the support of any tax policies. Existing home sales have also rebounded nicely from their lows in 2010. Meanwhile, pending home sales too have accelerated significantly. While new home sales declined from 321K to a seasonally adjusted annualized rate of 307K in December, on expectations of a rise to 321K from last month's revised 315K, it is not exactly a major concern. This is because buyers are likely to be more inclined to purchase an existing home given that new homes are relatively more expensive. As shown in the diagram below, existing homes are cheaper relatively to new homes. Presently, it costs approximately 25% more to purchase a new home. Given the difference in price, it's natural that buyers are inclined to purchase an existing home.

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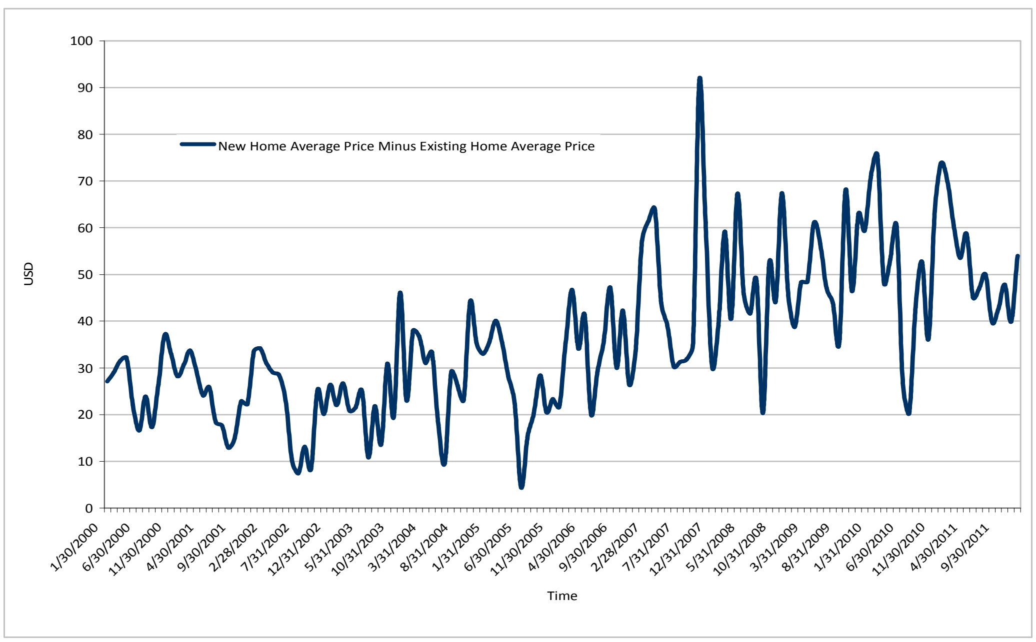
**Figure 5: Cheaper to buy an existing home**




*While new home sales is still on the decline, it is not exactly a major concern. This is because it is cheaper to buy an existing unit.*

*Source: Bloomberg, as of Dec 2011.*

The recent positive momentum is likely to stay in the near term and there are three reasons for this. Firstly, those who have been renting their properties might soon be pushed into buying their homes. Those who have rented are likely those who have chose to hang on their purchase while waiting for prices to bottom.

*Positive momentum in the housing sector is likely to continue in the near term and there are three reasons for this.*

Indeed, since 2010, the number of renter-occupied units exceeded the number of owner-occupied units. This trend is unlikely to continue as rents have been rising and this is likely to push potential buyers to eventually purchase their homes (instead of renting). Secondly, record low mortgage rates are also likely to encourage people to purchase their homes. Thirdly, housing prices are still at historically low levels and hence it might be deemed as an attractive level. Low housing prices and low mortgage rates make housing relatively affordable and this is reflected in the housing affordability index.

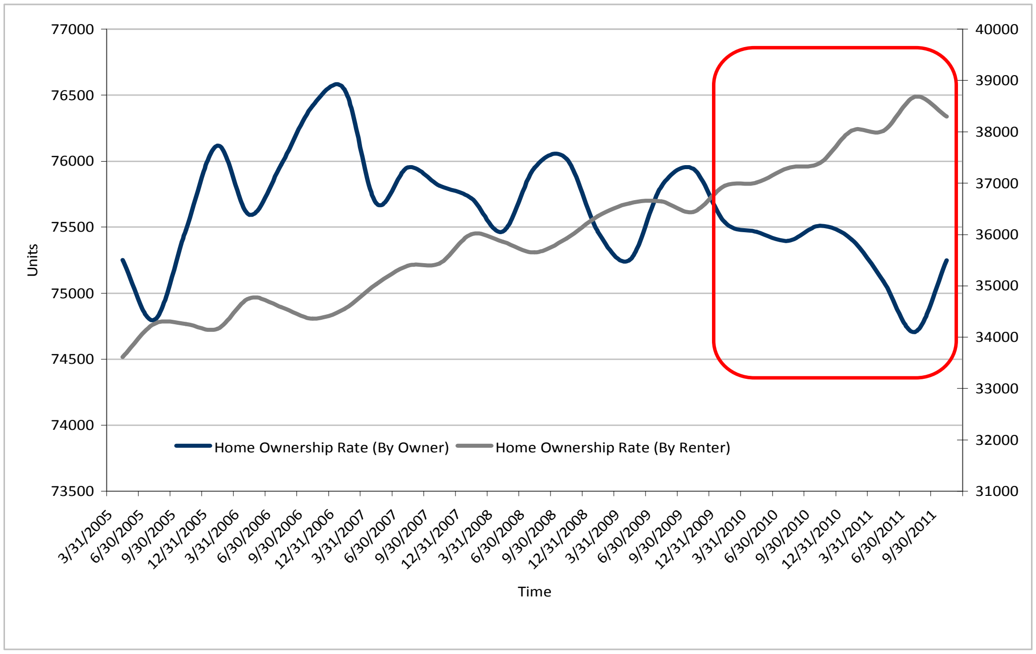
*Firstly, those who have been renting their properties might soon be pushed into buying their homes as rents have been rising.*

*Secondly, mortgages rates are at record low.*

*Thirdly, housing prices are also at historically low levels and have not rebounded in a big way.*

*Low housing prices and low mortgage rates make housing relatively affordable and this is reflected in the housing affordability index.*

**Figure 6: Renter occupied units exceed owner occupied units**

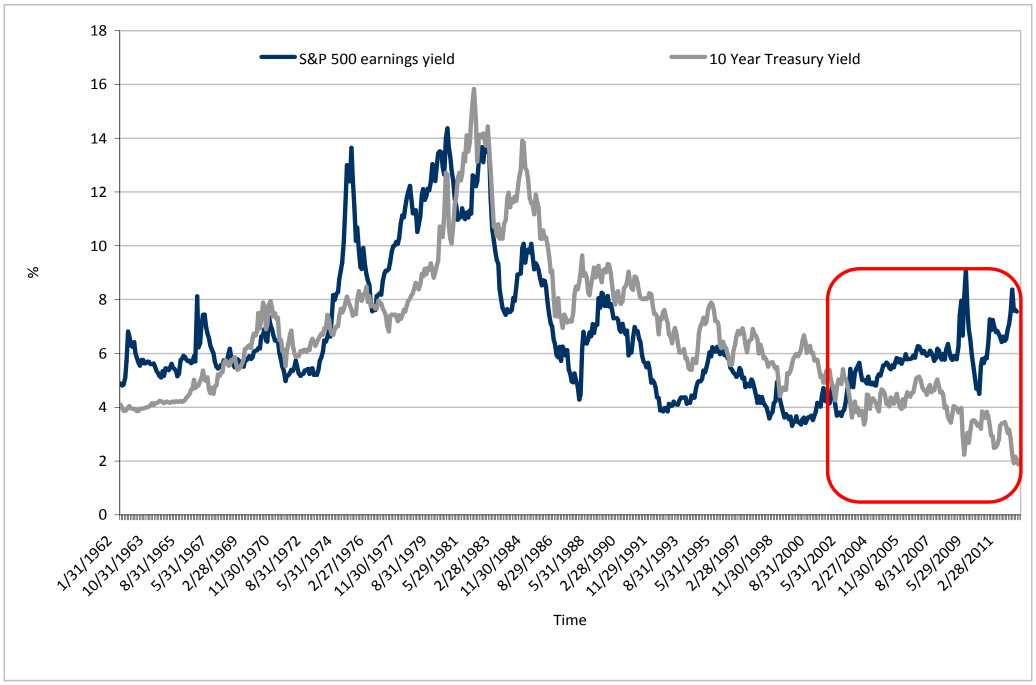



*Source: Bloomberg, as of Sept 2011.*

The downside to the above analysis is that there remains a multitude of homes in the foreclosure pipeline. To recap, back in Oct 2010, there was a joint effort in 50 states to investigate whether banks have used questionable documents to evict homeowners and foreclose properties. In conjunction with that, foreclosed properties were taken off the market. These homes have not been released back into the market. As such, while the months' of supply of homes has dropped, the trend could easily reverse when these excess inventories are released into the market.

In all, economic conditions in the United States are relatively sound at the moment. Despite so, there are still a number of internal structural problems that the country must work towards resolving. Nonetheless, earnings yield on equities is relatively attractive when compared against the yield on a 10 year treasury. This is shown in the next diagram. Hence, it is worth reconsidering having some tactical exposure to US equities.

**Figure 7: Yield on equities attractive to yield on 10-year treasury**




*Source: Bloomberg, as of Dec 2011.*

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