# Chart Focus: Chinese Property - A slow moving trainwreck

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INVESTMENT MANAGEMENT

Developed Countries 3 main avenues of growth are population growth, resource extraction and productivity. A 4th avenue for developing economies is through infrastructure spending. So here are 4 questions:

Who has the larger birth rate Italy or China?
Is China's GDP / capita closer to Botswana or the USA?
Are residential starts in China higher than 10 years ago?
What is steel consumption growth in the USA over the last 20 years?

The answers are China, Botswana, No and -2%.

When people discuss China, growth is always the main discussion. Is it 6%, maybe 4%? Rarely do we ask could it be 0%? We know that the labour market in China peaked some two years ago, so it can't be population growth and China depleted its own resources (including agriculture) many years ago.

**Figure 1: USA vs China yield per hectare – June 2022**

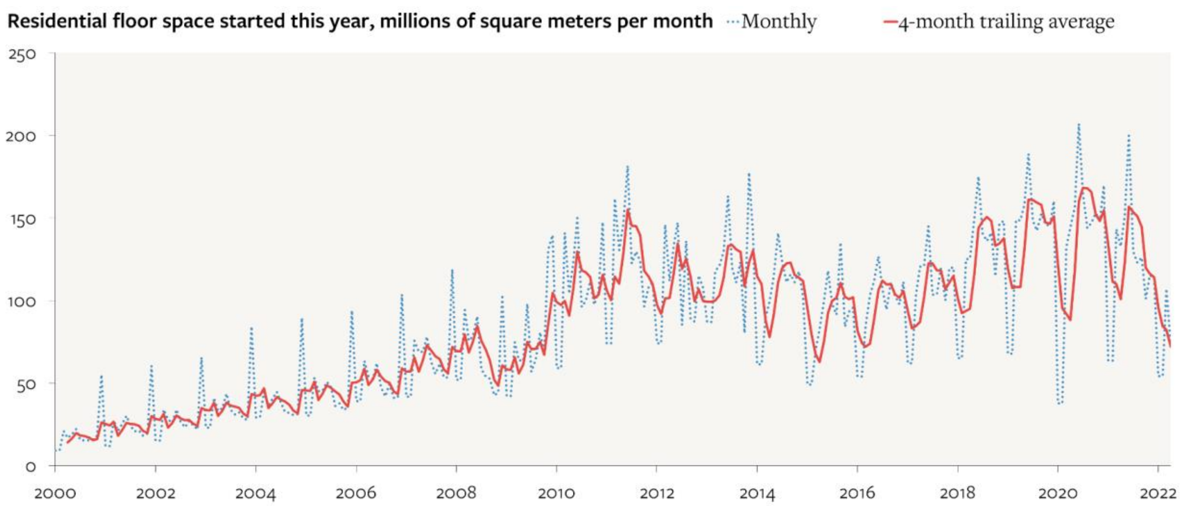
| | United States | China |
|---|---|---|
| Population | 329 million | 1.4 billion |
| Worlds Arable Land | 17% | 11% |
| Coarse Grain Yield *(metric ton per hectare)* | 10.4 | 6.1 |

*Source: US Census Bureau, Agweb, united states department of agriculture*

In terms of productivity many Chinese private firms have been productive, but this is negated by the growing share of the state. So we are currently in a situation where the Chinese Government is engineering growth through Infrastructure (good, bad or wasteful), growing the size of the state (can be good or bad) and financing it with debt. A large part of infrastructure spend was aimed at housing and urbanisation. So most people now believe that infrastructure spend at current rates, and housing supply is wasteful.

So it is no wonder that residential starts have been slowing. The residential value line would look different. Given SA resource bias it's no wonder that SA investors are worrying about the slowing infrastructure demand. Nobody believes the current iron price long term. Hence the low multiples. Analysts correctly regress volumes and margins lower when looking at the next 10 years for commodity companies. Remember US steel consumption has declined over the last 20 years.

**Figure 2: Residential starts slowing**



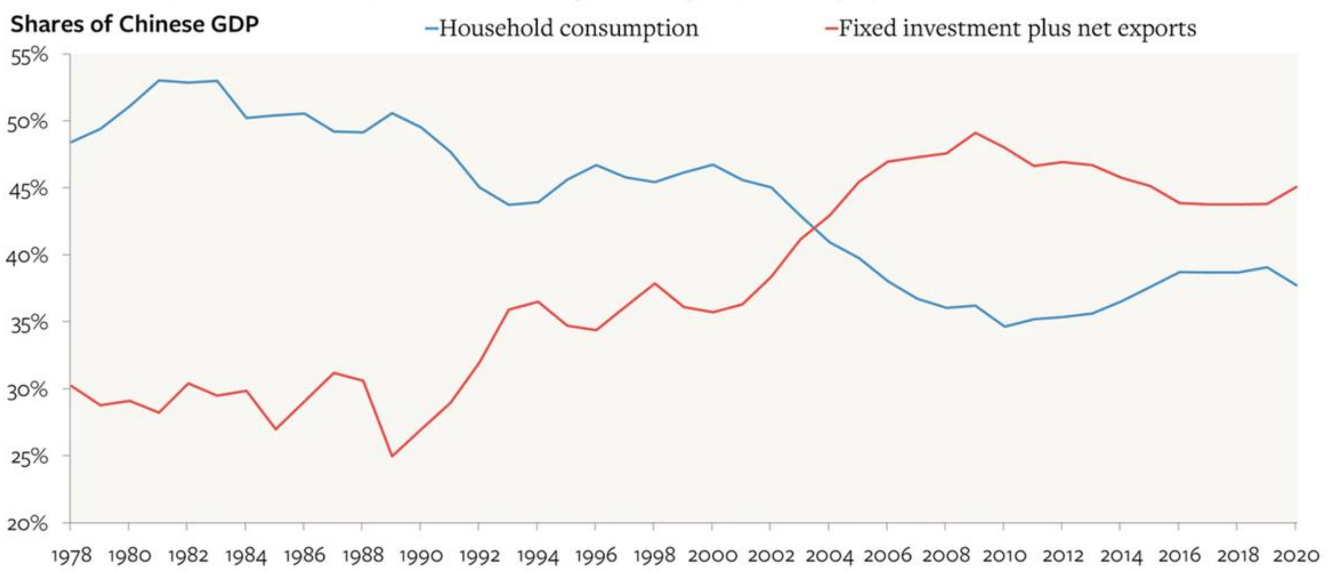



*Source: China National Bureau of Statistics, Matthew Klein calculations*

More importantly, going forward, what is the effect of residential asset prices either stagnating or falling?

From an investors perspective household consumption is key (as it is difficult to invest in the state). Below is a graph showing HCE (Household Consumption & Expenditure) as a % of GDP for China. As you can see it is declining and it is way below the levels in the USA of 60%.

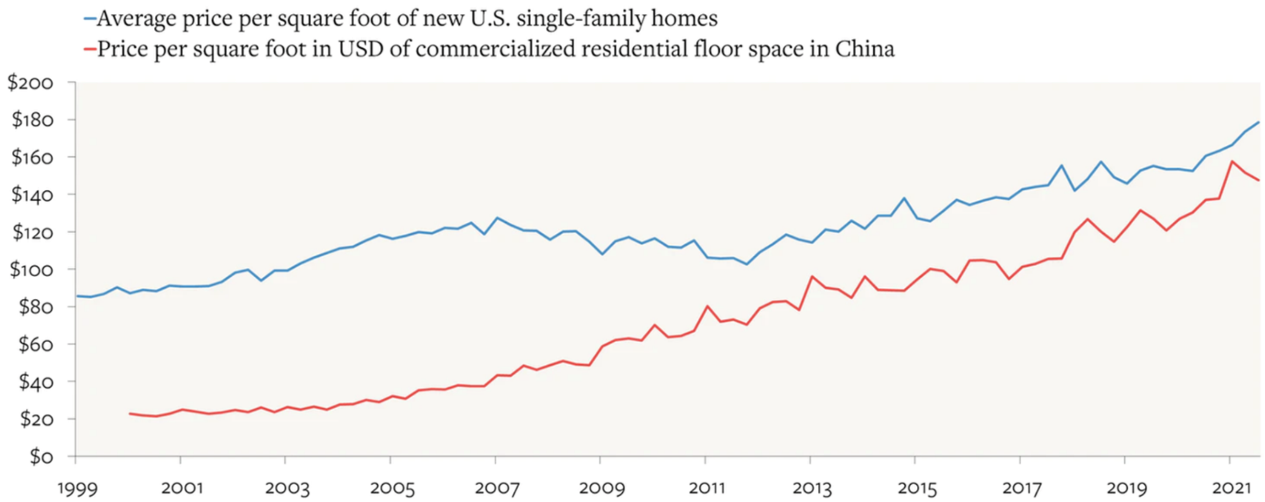
**Figure 3: HCE as a % of GDP**




*Source: China National Bureau of Statistics, Matthew Klein calculations*

In addition, the cost of housing eats up a huge amount of personnel income in China. Let's start by looking at the cost of residential housing through time compared to USA.

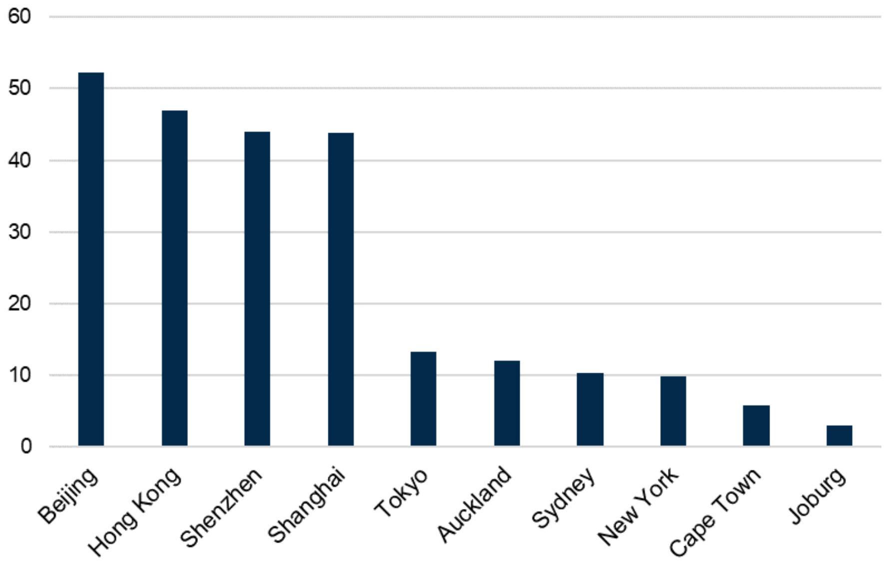
**Figure 4: Housing prices per square foot**




*Source: China National Bureau of Statistics, U.S. Census Bureau, Federal Reserve Board, Matthew Klein calculations*

China's number is quite close to the USA which is ludicrous given that the USA GDP/capita is 6 times that of China. (Please don't use PPP). This affordability index by Numbeo shows Chinese cities dominating the ladders. Sydney is at 11 while Beijing is at 52.

**Figure 5: Affordability Index using price to income ratio**




***Price to income ratio shows how much net income is required to purchase a property*

*Source: Numbeo*

Looking at the above numbers, a huge amount of property in China is bought for investment or speculative purposes. Residential property in China is a speculative bubble on a large scale.

The wealth effect on the way up is great and it is necessary. You want your population to be getting wealthier. But falling house prices has a massive effect not just on household finances but consumer confidence and spending.

A bigger problem is trying to deal with an asset bubble that is deflating.

In order to delve further we need to look at the word "bezzle". The three statements below explain it perfectly:

Economist John Kenneth Galbraith wrote "Weeks, months or years may elapse between the commission of the crime and its discovery. (This is a period, incidentally, when the embezzler has his gain and the man who has been embezzled, oddly enough, feels no loss. There is a net increase in psychic wealth.) At any given time there exists an inventory of undiscovered embezzlement in—or more precisely not in—the country's business and banks"

British economist John Kay explains "The joy of the bezzle is that two people—each ignorant of the other's existence and role—can enjoy the same wealth."

Vice chairman of Berkshire Hathaway, Charles Munger states "If a foundation, or other investor, wastes 3% of assets per year in unnecessary, non-productive investment costs in managing a strongly rising stock portfolio, it still feels richer, despite the waste, while the people getting the wasted 3% think they are virtuously earning income. The situation is functioning like undisclosed embezzlement without being self-limited. Indeed, the process can expand for a long while by feeding on itself. And all the while what looks like spending from earned income of the receivers of the wasted 3% is, in substance, spending from a disguised "wealth effect" from rising stock prices."

I'm sure the Chinese authorities are aware of the problem hence some bizarre solutions: Firstly the local governments rely on land sales to support 30% of local govt spending.

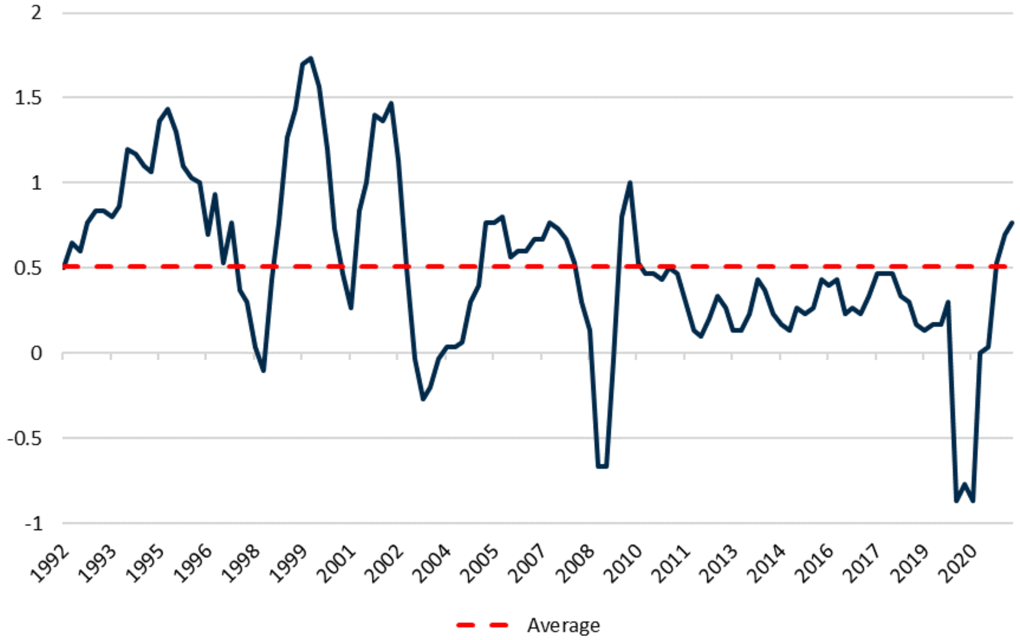
To fill in the gap vacated by broken property companies they have created subsidiaries owned by the local government to buy the land (financed by debt in the subsidiary).

To keep up the illusion of wealth many cities now have a floor on the price that apartments can be sold for. Not to protect the property companies but to protect the citizens who borrowed money to buy apartments at a higher price.

And of course we also have price ceilings to maintain the charade of common prosperity. I'm sure Zuma wished he had coined that phrase.

This is not a problem that can be solved by goal seek on Excel. So what does the future hold for Chinese property going forward? We do have 3 good examples of property bubbles deflating. The USA in 2008 is not a good example as prices were allowed to clear. Also there was no government involvement on infrastructure and housing. South Korea (1997) and Japan (1980's) were very close replicas. Both were characterised by over 20 years of 0% HCE.

**Figure 6: South Korea Real GDP contributions by expenditure - Private Consumption SA**




*Source: Bloomberg*

It is very unlikely that the Chinese government will just allow prices to clear (Lehman style 2008) so the path forward is probably the path followed by Japan and South Korea. Both countries also had very subdued demand post the deflating of their property bubble. They also both made the mistake of having policies which supported the supply side (infrastructure & export sector) at the expense of the demand side (household consumption). In the last 2 years China has shown a similar trend supporting the supply side and not the demand side. Lastly, post the peak of the property bubble, the demographic situation (at the time) in South Korea and Japan acted as a tailwind where in China the demographic situation is already a strong headwind.