CIO Perspectives

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Daryl Ho, CFA
Strategist

CREDIT STRATEGY

Warranted caution remains with China Property

Key points

- Risks have broadened beyond the China property sector with mortgage boycotts now threatening banking sector assets, along with evidence of social discontentment escalating beneath the surface
- Policy considerations of (a) a state-backed property bailout fund, and (b) the issuance of special purpose bonds to acquire inventory from troubled developers are not expected to catalyse a quick recovery in the distressed China property offshore bond market
- Such developments reinforce our cautious stance on the sector. Investors with exposure to China property bonds should ensure that positioning not be outsized against our recommended asset allocation weights towards EM bonds
- We maintain a preference to be up in quality with DM IG credit in this environment

Broadening of property risks. The onset of a wave of mortgage boycotts from disgruntled homebuyers has stoked fears of a contagion-like vicious cycle in a sector already beset with systemic distress. While it merely began with fewer than 30 projects across the country, it quickly spread to more than 300 unfinished projects across major cities within a week. Adding insult to injury is the fact that construction contractors and suppliers have joined in the fray, threatening to withhold repayment of bank loans in protest of non-payments from distressed developers. Left unchecked, such a non-linear decline in sentiment can rapidly degenerate into broader financial instability, an outcome that we had surmised when we pivoted to a posture of prudence for the sector in March this year.

Recurring restraint in government response. In response to the developing crisis, China has announced plans to set up a state-backed property bailout fund with an initial size of CNY80b (with an option to upsize to CNY200-300b) to extend liquidity support to 12 property developers. This is by no means a silver bullet for the afflicted property sector, given that our estimates of monetary support required to contain project delivery risks come closer to CNY1.1t (Table 1). Media had also reported that the State Council is considering the issuance of special purpose bonds to acquire housing units from troubled developers for redevelopment into social rental housing, which would provide liquidity through the monetisation of unsold inventory but not sufficiently boost demand for a sustained recovery. On aggregate, the recent spate of policy support measures is unlikely to be the catalyst that would reverse the fortunes of the distressed China property offshore bond market.

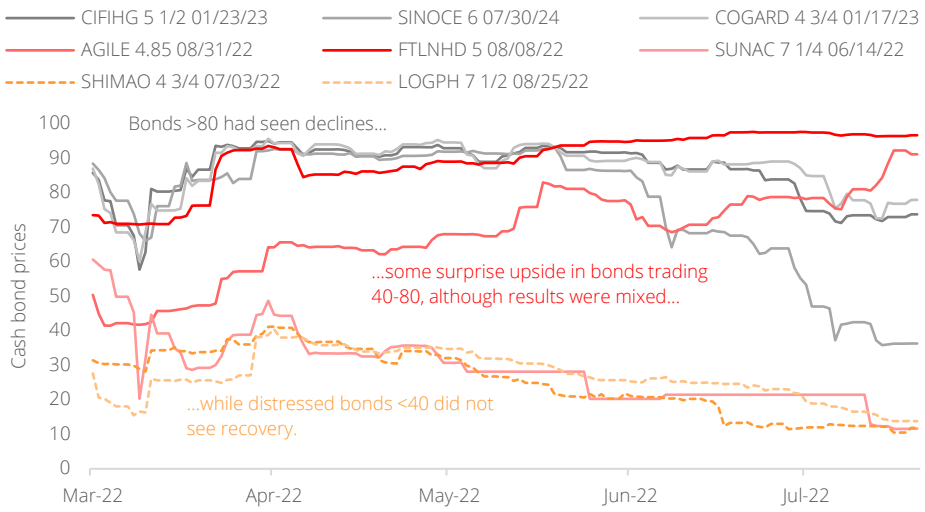
Table 1: Scenario analysis of monetary support required to contain delivery risks

	Construction costs paid upfront		
CNY(b)	10%	30%	50%
Projects subject to delivery risk		Base case	
All POE projects (balance construction costs)	7,537	5,862	4,187
All liquidity-troubled developer projects	4,766	3,707	2,648
30% of liquidity-troubled developer projects	1,430	1,112	794

Note: Liquidity-troubled developers refer to those who have entered bond extensions or defaults (inclusive of offshore or offshore markets)
Source: DBS

Taking stock of our cautious stance. We had recommended a two-pronged approach to the sector in March this year for investors holding single-line developer bonds, advocating that (1) those with bonds trading in >80 cash price ranges take some money off the table to hedge against rising risks of broader sectoral distress, while (2) those with bonds in deep distress consider holding/reducing if prices are trading below/above recovery values respectively. Since then, the higher priced bonds (>80) have broadly seen declines, while weaknesses remained with the distressed bonds, although select names saw asymmetric upside on positive developments – judging from the price movements of select short-dated offshore BBB/BB China property bonds (Figure 1).

Figure 1: Mixed performance of short-dated offshore BBB/BB China property bonds



Source: Bloomberg, DBS

Investors should remain up in quality in credit. The relatively underwhelming policy response from authorities at present would unlikely result in a quick turnaround in the offshore China property bond market – revealing the state's prioritisation for reducing moral hazard concerns over risks to financial stability. This continues to validate our cautious stance in Emerging Markets (EM)/High Yield credit, with a preference for short-dated Developed Markets Investment Grade bonds for defensive posturing as reflected in our 2Q22 Credit outlook – Rate Hike Headwinds, as well as our 3Q22 Credit outlook – Quality over Cash. Investors with exposure to China property should ensure that positioning in this sector be in line with our recommended asset allocation weights towards EM bonds, reducing any outsized exposure if necessary to manage risk.

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