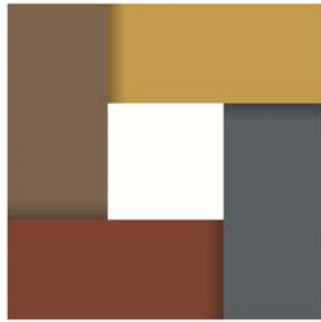


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How Overbuilt is China?

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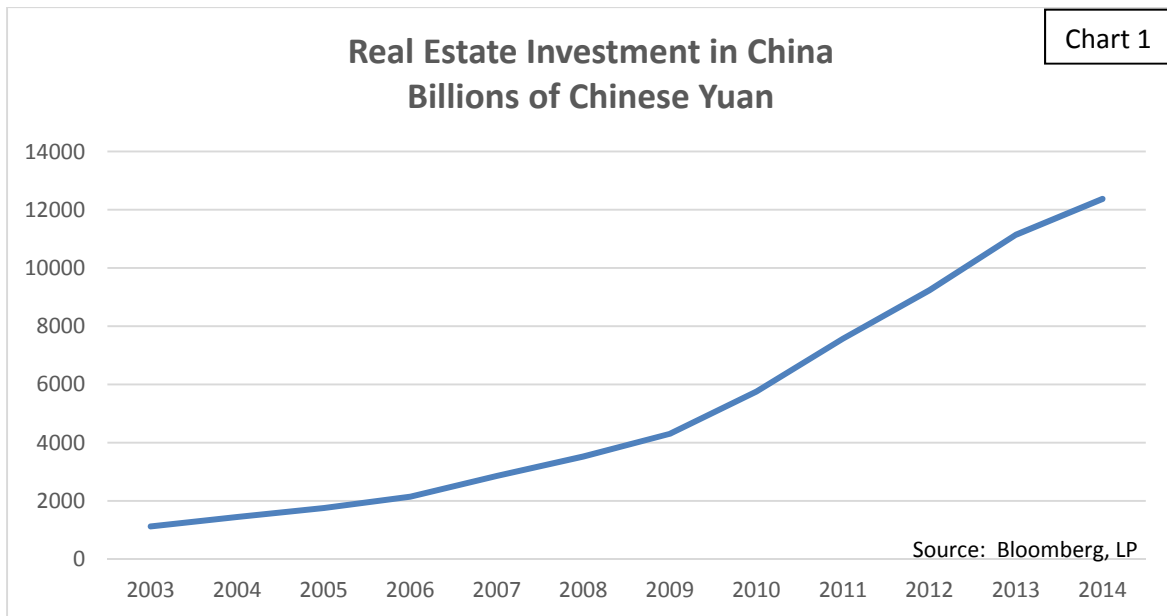
In our March 2014 GHPIA Global Markets letter¹, we analyzed the sources of slowing economic growth in China, with particular emphasis on the property boom turning bust. China's economic growth averaged 9.8% per year over the past 35 years, and their current growth target is around 7%. We believe around 5% is a more likely outcome over the next five years, based on our analysis of Chinese economic data. Construction is now falling as are exports – two leading sources of growth (for an analysis of China's currency and the export slowdown please see this quarter's Investment Insight Newsletter²). Taking up some of the slack, however, are services and household consumption expenditures.

The Chinese government reacted to the global financial crisis of 2008 and 2009 with a massive stimulus program. The major component of this program was generous lending by state-owned banks to state-owned companies. These companies, in turn, used much of the cash to either invest in real estate directly or to fund private real estate developers. Chart 1 shows the surge in real estate investment.

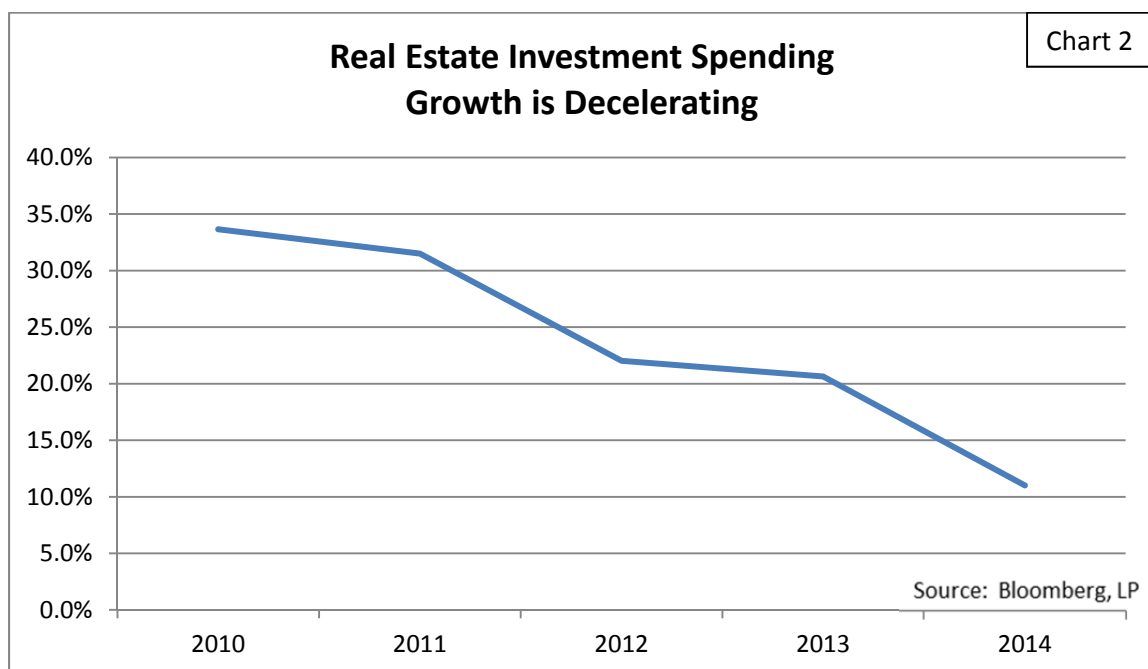
¹ *China: 35 Years of Rapid Growth...How Many More?* Available on our website at: www.ghpia.com

² *The Almighty Dollar...and Yuan?* Available on our website at: www.ghpia.com

The stimulus program helped China avoid the economic meltdown, but reigning in the real estate boom proved more difficult.



As the financial crisis ebbed and the property boom gathered steam, the People's Bank of China (PBOC; China's central bank) tapped on the brakes. In late 2010 and 2011, the PBOC boosted its benchmark interest rate from 5.25% to 6.5% and tightened lending standards. As you can see in Chart 2, construction spending slowed from a blistering growth rate of 33% in 2010 to 22% in 2011, and 11% in 2014.



According to an index of China's 70 largest cities published by the National Bureau of Statistics new home prices fell an average of 4.3% in 2014 and are down a further 3.2% so far in 2015. These price declines indicate China's urban areas are indeed overbuilt. Unfortunately, China does not publish reliable data about the size or quality of its housing stock. Therefore understanding the magnitude of the problem is quite difficult.

Alarmist articles in the press draw parallels with the U.S. housing bubble. While recognizing the weakness of available data, our analysis suggests these claims are exaggerated. Perhaps most importantly, Chinese government debt is only 15% of Gross Domestic Product (GDP) compared with 60% in the United States prior to the financial crisis (and 71% at present). The Chinese government retains the financial firepower to contain a real estate induced banking crisis.

The property market in China is vastly different than in the United States. China's urban population is growing by 2% to 3% annually, generating demand for 3 to 5 million new dwellings each year. Commercial real estate requirements are similar. Many of China's 168 million urban households (based on 2012 data) live in shoddy buildings, often built before China's transition to a market economy. Incomes are rising rapidly from very low levels creating significant demand for upgraded homes and furnishings. Developers built homes, apartments, retail and office buildings ahead of demand, but absorption of excess supply is faster than in more developed countries.

Chart 3 is an attempt to visualize our analysis of Chinese overbuilding. Easy lending during the 2008 – 2010 time period most likely borrowed demand from the future, but the future is now here. The total income of urban households grew by 10.5% per year from 2008 through 2014. Meanwhile, total real estate investment spending grew by 23.2% annually during the same time period. The blue line in Chart 3 is our estimate of steady-state demand for real estate in the Chinese economy based on urban income growth. The solid red line is actual demand including the spike in construction resulting from the stimulus program. The dashed red line outlines the period of under-investment required to clear China's current real estate glut.



Chart 3 is merely a plausible scenario based on unreliable data and certainly not a definitive forecast. It seems clear a period of real estate contraction is required to balance the excess supply generated during the boom. Falling home prices in China's cities and collapsing raw material prices on global markets indicate this process is well underway. Two pillars of China's growth – exports and construction – are turning down, even as other areas such as services and personal consumption continue to grow. Data regarding the real estate market is incomplete and tricky to interpret. Estimating the size of the glut, therefore, requires conjecture. Our view is that China can absorb the losses from a property downturn without a financial crisis, but it will come at the cost of slower economic growth.