Will A Chinese Real Estate Bubble Take Down Asian Stocks?

November 9, 2011
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Although China's economic leadership seems to have been successful in engineering a "soft-landing" for the Chinese economy, recent weeks have brought news of some turbulence: There has been a collapse in real estate asset prices in some urban Chinese markets, as years of hot credit and enthusiastic building collide with a cooling economy. Some property owners have dropped prices by 20 to 40 percent in the last year in a war to attract buyers. Some observers are claiming that the Chinese real estate bubble is finally bursting - and the more bearish of them believe that the bubble will take a sizeable chunk out of the Chinese economy with it.

There is no doubt that the Chinese construction boom, fueled by years of easy money policies and goosed by an immense $580 billion stimulus effort has gotten ahead of demand. Photographs of China's "ghost cities" are a staple of financial journalism in the west. What remains to be seen, however, is to what extent a deflation of real estate prices will affect China's growth - and how China's landing, however soft or hard it may be - will affect its neighbors.

External Factors

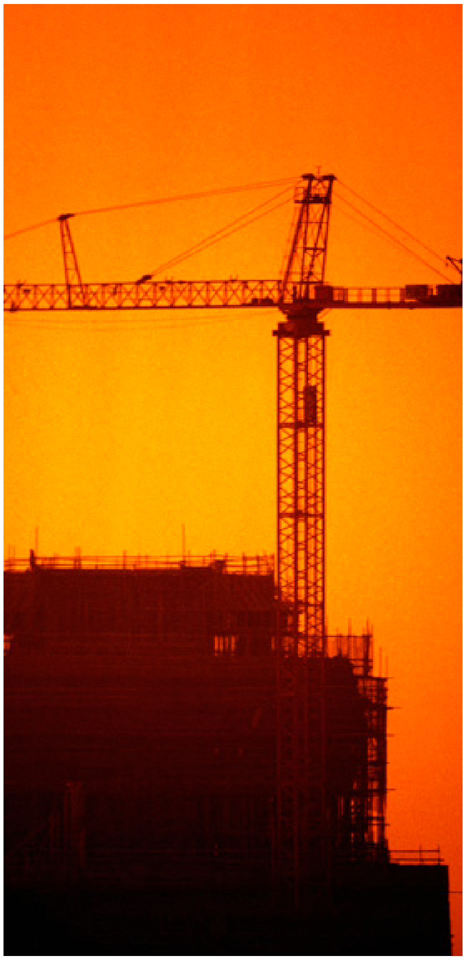
The Peoples' Republic of China, of course, makes up the center of gravity of the Asian economies, and in the past, has been the primary engine pulling Asian economies along through a sharp global recession. Yes, China has significant exports to the sluggish U.S. economy, as well as to a European economy that is now teetering on the brink of another severe slowdown, thanks to their own sovereign debt crisis.

In past years, these exports have assisted the development of other Asian economies, because of the steady demand for raw materials and upstream manufacturing. For example, Chinese factories were importing circuit boards designed in America and Japan from Singaporean factories, slipping them into chasses manufactured in Thailand, and then shipping the whole thing back to the United States. In 2006, for instance, only $4 of a $150 iPod manufactured in China for export to the west could be attributed to value added in China itself. This is because Chinese workers simply assembled finished components manufactured elsewhere.

A recent study from the Center For Interuniversity Center for Research and Analysis of Organizations examined Chinese imports and exports, and found that only a fraction of the total value of Chinese exports represented value actually added in China. Instead, China imported much of the manufacturing process from upstream manufacturers. Once you netted out the imports from the exports, China wasn't nearly as dependent on manufactured exports to the west as their gross export figures - amounting to over 50 percent of GDP, would indicate. The real figure, according to these researchers, was about half that (Van Assche, 2009).i The takeaway is that the Chinese economy is not as export-dependent as many analysts assume. There is much more to the Chinese economy than cheap labor assembling widgets and selling them to the west.

Internal Factors

The transformation of Chinese society from a poor agrarian society to a modern industrial society with a functional middle class has been astonishing - but is nowhere near complete. Nevertheless, urban Chinese have gotten a taste of consumerism, and they are not going to be giving it up anytime soon. Upwardly mobile Chinese have become consumers in their own right, generating rapid growth in domestic demand for everything from cell phones (and cell service) to McDonalds food to modern health care. Increasing domestic demand can help counter the effects of a slowdown in Europe and elsewhere, just as a resilient American consumer



managed to stave off recession in the U.S. longer than many observers predicted.

The rapid decline in real estate asset prices in parts of China is not pleasant, but it is a natural outgrowth of the runup from prior years. But manufacturing remains strong: During the first week of November, the latest Markit index figures showed that China's manufacturing output had actually increased at the fastest rate in six months. Export orders were growing faster than they had in almost a year, and overall orders rose for the first time since last summer. While the price of an apartment did decline, all indications are that the current moderate 8-10 percent rate of growth is sustainable, in both manufacturing

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> **--Khiem Do, Manager, Asia Pacific Fund, Inc.**

and nonmanufacturing sectors.ii "More sensible investors know China will continue to grow," argues Khiem Do, portfolio manager of the Asia Pacific Fund, Inc., a closed-end fund specializing in the region. "Even a slow pace of growth for China is 8 to 9 percent. Those who think China is falling off the cliff are really in a big minority. Very few people truly think that and are acting on it."

The ASEAN Connection

Even if the Chinese economy falters, what will be the spillover into the surrounding economies? Surprisingly little. As rapid as Chinese growth has been in recent years, China still only accounts for a small minority percent of the total ASEAN export picture. iii And when you factor out Chinese imports that are really just processed and then forwarded to meet western demand, the ultimate reliance of ASEAN countries on Chinese economic growth is even less.

In fact, nearly half of ASEAN exports go directly to the U.S. and Europe. ASEAN is far more dependent upon Japanese demand than on Chinese (ibid). A substantial contraction in the Chinese domestic economy will hurt, but it will not be a crippling blow.

On the other hand, if China's economy withstands its real estate troubles and maintains its expected 7-10 percent economic growth, the other Asian countries stand to benefit a great deal, over time.

Consider: As the Chinese middle class grows, so will their own demand for electronic goods, computers, cars and other goods with significant manufacturing input from all over Asia. Chinese citizens currently consume about 30 percent of Chinese production, but if this figure should rise to 50 percent - entirely in line with long term Chinese history and the experience of many other modern economies - Asian factories will be in a position to pick up the demand.

Money is Power

Yes, Chinese economic problems are very real. Chinese authorities are currently dealing with a crisis of overbuilding in some areas of China, problems in the banking industry, and graft and corruption. They are also working hard to maintain manufacturing market share against increasing competition in Thailand, India, Bangladesh, Pakistan, Indonesia and Viet Nam. China also sits on a vast "floating population:" some 220 million souls who have migrated from the provinces to seek work in the cities, but few long term prospects, limited coverage from the Chinese social welfare system, and no long-term roots in the city. A severe contraction could cause a massive reverse migration back to the farms, potentially setting the Chinese economy back years.

China, however, has a secret weapon: A massive combination of currency reserves and sovereign wealth funds. Japan's currency reserves now total over $3 trillion - nearly three times the size of Japan's reserves, the world's closest runner up. In contrast, the U.S. maintains reserves of $143 billion, backing an economy five times as large.

These massive liquid reserves give China enormous leeway that American policymakers could only dream of. For example, if push came to shove, China could prop up nearly any currency it chose, or hold its own down to maintain its competitiveness, simply by intervening in global markets. It could also pull out the defibrillators and jumpstart any faltering economy via massive stimulus program - dwarfing anything the U.S could contemplate. They could raise even more cash by selling off state monopolies or land. Although there are downsides to each of these actions, China certainly has them at its disposal.

Monetary Policy

Monetarily, China is also fairly far along in its own tightening cycle. China has raised reserve requirements on banks three times in the last year, for example, to reign in runaway lending. China can loosen the screws just as easily as tighten them. This would lead to a situation in which the Chinese economy entered a loosening cycle just as western economies are in an austerity cycle, with the attendant increase of capital flows to China and Asia.

Valuations

Asian stocks are still com pellingly valued at under ___ times earnings. Most closed-end funds specializing in the region are even trading at discounts of between 7 and 12 percent to NAV. Meanwhile, expected growth rates dwarf those foreseen in the west for a long time to come, making Asia even more attractive on a PEG basis. Asia ex-Japan still boasts the fastest-growing economy in the world, according to Mr. Do.

Furthermore, Asian stocks are still less leveraged than their American peers. The combination of attractive valuation, relatively strong balance sheets and continued growth makes for a compelling case for significant exposure to Asian equities in any diversified portfolio. Even if China's problems are more severe than anticipated, ASEAN markets still have adequate global diversification in export markets, and substantial room for growth. ■