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Noodle Shops, Pigeon Cages

China cooling its overheated property market;
A delicate balancing act

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Equity markets declined during October as investors were worried about two electoral tail-risks: a Trump presidency (too much uncertainty) and a Democratic sweep (higher taxes and more regulations). The plot thickened after FBI Director Comey became this Halloween's bogeyman to the Clinton camp by announcing the reopening of the email investigation. Treasury bond yields rose as markets priced in higher odds of a December federal funds rate hike. Investors also started to anticipate higher inflation due to rising wages and crude oil prices, the latter, however, declined by month end after OPEC failed to reach a production agreement. These factors drove up the U.S. dollar while the renminbi continued its gradual devaluation. The earnings season was mostly above expectations, and U.S. corporations appeared to be positioned for several quarters of accelerating earnings growth due to easier comparisons. However, several bellwether industrial companies issued disappointing guidance, signaling a still mixed economy. AT&T's proposed $85 billion acquisition of Time Warner brought up a sense of déjà vu: Time Warner was once gobbled up by AOL during the peak of the dot-com bubble in 2000; could AT&T's offer, which will raise $40 billion of debt, be a sign of the top in the bond bubble? The search for yield was so desperate that Austria's €2 billion *70-year bond* had an order book of €7.8 billion and was priced to yield at just 1.53%! Looking at the bright side, at least it had a positive yield.

Equity Markets Indices[1]	9/30/2016 Price	10/31/2016 Price	MTD Change	YTD Change
MSCI All Country World	418	411	-1.8%	2.9%
S&P 500	2168	2126	-1.9%	4.0%
MSCI EAFE	1702	1666	-2.1%	-2.9%
Russell 2000®[2]	1252	1191	-4.8%	4.9%
NASDAQ	5312	5189	-2.3%	3.6%
TOPIX	1323	1393	5.3%	-10.0%
KOSPI	2044	2008	-1.7%	2.4%
Emerging Markets	903	905	0.2%	14.0%
Fixed Income				
2-Year US Treasury Note	0.76%	0.84%	8	-21
10-Year US Treasury Note	1.60%	1.83%	23	-44
BarCap US Agg Corp Sprd	1.38%	1.32%	-6	-33
BarCap US Corp HY Sprd	4.80%	4.77%	-3	-183
Currencies				
Australian (AUD/$)	1.31	1.31	-0.7%	4.4%
Brazil Real (Real/$)	3.26	3.19	2.2%	24.0%
British Pound ($/GBP)	1.30	1.22	-5.6%	-16.9%
Euro ($/Euro)	1.12	1.10	-2.3%	1.1%
Japanese Yen / $	101	105	-3.3%	14.7%
Korean Won / $	1101	1144	-3.7%	2.8%
Commodities				
Gold	1316	1277	-2.9%	20.3%
Oil	48.2	46.9	-2.9%	26.5%
Natural Gas, Henry Hub	3.03	2.79	-7.9%	20.7%
Copper (cents/lb)	221	221	-0.2%	0.2%
CRB Index	186	186	0.0%	5.7%
Baltic Dry Index	875	857	-2.1%	79.3%

SOURCE: BLOOMBERG

Reminiscing the Go-Go Days

In 1990, I was excited to assume the role of lead marketing representative at IBM for several of its Japanese banking clients in New York City. At the time, the world's ten largest banks by assets were all Japanese banks, and several of them had global expansion ambitions. Strolling down the glitzy streets of Ginza during my first business trip to Tokyo in 1991, I was in awe of the area's glamour and affluence. It was reported that Ginza's choice properties in 1989 were commanding more than $1.5 million per square meter, or $139,000 per square foot. I recall reading about an owner of a small noodle shop who had turned down a $20 million offer from land developers; a few years earlier, a soba noodle shop owner in Tokyo's financial district had reportedly sold his 450-square foot store for $14 million. Bear in mind, these were the late 1980s dollar figures, and they are worth more than twice as much today.

At Shibuya Crossing, where five major crosswalks converged, I was dazzled by the flashing neon signs on the surrounding buildings and felt the rush of hundreds or perhaps thousands of pedestrians crisscrossing briskly when the walk light turned green. It seemed like everyone was going places. Japan Inc. was admired and feared by the rest of the world. Western academics were busy espousing the virtues of Japan's just-in-time manufacturing (JIT) and continuous process improvement (Kaizen). Pop culture painted Japanese businessmen as ruthless samurais scheming to subjugate the world. Buoyed by a strong yen that had roughly doubled in value against the greenback from 1985 to 1988, Japanese companies were busily acquiring foreign assets, including trophy properties such as Pebble Beach Golf Links and Rockefeller Center.

Little did I know at the time that Japanese equities and property prices had already peaked in 1989, and it was just the beginning of a long, painful decline. Today, more than a quarter century later, Japanese policymakers are still trying to find a way back to sustained growth and inflation. As for my stint selling IBM solutions to Japanese banks, well, let's just say it was a valuable lesson for my investment career as I was able to experience how business and the economy operate in the real world rather than on spreadsheets.

China's Real Estate Boom

During a recent trip to China, the topic du jour was the country's red hot housing market. In the wake of last year's precipitous stock market decline and overcapacity in heavy industries, Chinese policymakers have sought to reflate the housing market as a way to rekindle economic growth. To that end, they have been far too successful. A friend's 180-square meter apartment in Beijing, which he had purchased for ¥4 million seven years ago, was getting unsolicited cash offers of ¥24 million ($3.6 million), implying unit prices of over ¥130,000 per square meter and $1,850 per square foot. In the southern tier-one city of Shenzhen, the affordability has become so tough that a developer recently introduced miniature apartments dubbed "pigeon cages" by the locals. These six square meter units (65 square feet), complete with a full bath, kitchen, and a wall bed that folds into a closet, sold for ¥880,000 each ($130,000), or ¥147,000 per square meter (roughly $2,000 per square foot). For years, one of the justifications of rising prices in tier-one cities was that they should reach parity with major global metropolises. Well, it looks like they have arrived, but at much higher price-to-income ratios. So how will they justify further price appreciations?

> A bursting of the Chinese real estate bubble will not be contained to just China; the shockwave will reverberate far beyond its shores.

At the start of 2016, the sharp price appreciation was confined to China's tier-one cities. Lately, however, many tier-two and tier-three cities have seen prices rise more than 40% from a year ago. The skyrocketing prices have led to a bidding frenzy for land, as many large state-owned enterprises in manufacturing, utilities, and even aerospace leveraged their access to cheaper bank credits to foray into real estate. In many instances, land auctions went on for several hundred rounds of bidding, and the winners wound up paying prices several multiples of the opening bid, well in excess of existing real estate prices. One local analyst quipped that the situation is akin to seeing the price of flour being more expensive than the bread.

Since the start of the Golden Week holidays on October 1st, multiple cities have rolled out administrative measures aimed at cooling the property market. Recent data has shown softening in both prices and transaction volumes. However, it's a delicate balancing act as China cannot afford to let the property market over-correct to the downside. Real estate plays a uniquely important role in the Chinese economy. China's home ownership rate, at about 90%, is among the highest in the world. It is a vestige from the old days when employees were provided with company housing. Over time, they were allowed to purchase these units at significantly below-market prices. Housing is thus a form of savings for many Chinese, and most city dwellers have felt the great wealth effect over the last couple of decades. A cab driver in Beijing told me that his 75-square meter two-bed room apartment in the second ring of the city, purchased for ¥170,000 in 2001, was getting bids for five to six million yuan. The mid-point of that range would imply a 32 fold increase and 26% annualized appreciation.

Real estate also accounts for about 70% of the collateral for loans in China, not to mention its impact on construction activity, raw materials, and so forth. Many municipalities still depend on land sales as an important source of revenues. Based on these factors, many Chinese believe the government cannot afford to let property prices fall too much. One of my Chinese contacts has assuredly proclaimed that the biggest lie in China over the last fifteen years was that Chinese real estate was about to crash. I couldn't help but think of the poor Japanese noodle shop owner who allegedly turned down $20 million in the early 1990s, and the U.S. official who said in 2005 that the U.S. has never had a decline in housing prices on a nationwide basis.

It's a Connected World

One metric that China bears tend to focus on is the rapid growth in the country's total debt (private and public debt combined), which has surged from 164% of GDP in 2008 to about 250% today. Such a rapid buildup in leverage, based on historical precedents, should raise many warning flags. Chinese researchers, however, argued that such a concern is premature since Japan has built up its total debt to over 600% of GDP, and various European countries are getting by at over 450%. With China being a net creditor country (thus not dependent on foreign capital to finance its public debt), and its major banks being state-owned, they do not see reasons why China could not continue to increase its leverage for growth. In the near to intermediate terms, with the top echelon of China's leadership about to go through its quinquennial transition, growth and stability will likely be maintained at all costs. However, with real estate now overheated, what will be the next growth driver?

Beyond the next 12 to 18 months, we believe it may be in China's best interest to dial down the growth target to prioritize quality over quantity. The current growth mode, which depends on continued stimulus and ever growing leverage, has created much inefficiency and overcapacity. How China manages the transition will have ramification on the global growth outlook, exchange rates, inflation expectation, and even your property prices. While Japan's outbound capital in the late 1980s was largely led by business investments, China's rise has recently been accompanied by growing individual outbound investments and emigration. The first-order effect can be felt in property prices in places such as Vancouver, Toronto, Los Angeles, Sydney, and the like. At times, it felt like Chinese buyers were bidding up foreign properties with the fervor of its domestic housing bubble. Ironically, should the Chinese economy run into trouble, the pace of capital outflow would initially accelerate, potentially putting downward pressure on the renminbi while bidding up property prices in major cities outside China. Global trade would then take a hit, followed by a deflationary shock and recession across much of the world. In short, a bursting of the Chinese real estate bubble will not be contained to just China; the shockwave will reverberate far beyond its shores. Let's hope, for the sake of the global economy, that Chinese policymakers manage to successfully engineer a soft-landing in its overheated real estate market.●

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[1] Index pricing information does not reflect dividend income, withholding taxes, commissions, or fees that would be incurred by an investor pursuing the index return.

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