What happened?

On 1 October 2014, the People’s Bank of China (PBoC) and the China Banking Regulatory Commission (CBRC) announced measures to officially relax mortgage restrictions to help spur higher demand for Chinese properties.

The key measures relating to household mortgages include:

- Allowing banks to cut the mortgage loan rate for first home buyers: from a 5-10% discount previously up to a 30% discount on the benchmark rate;
- Relaxing restrictions on second home purchases: as long as the initial first home mortgage has been fully paid off, second home purchases can be treated as first home mortgages benefiting from lower mortgage loan rates and a lower down-payment requirement;
- Removing the ban on third home mortgages.

Housing upgrade demand is estimated to account for 40-50% of transactions, so the lowering of restrictions for second home purchases could provide a strong driver to a recovery in transactions. There were also measures to support funding of quality property developers and bank lending activities. Property developers will be allowed to issue corporate bonds in the interbank bond market, whilst commercial banks are allowed to issue mortgage-backed securities and long-term special purpose financial bonds to support mortgage lending. Banks are encouraged to support the financing needs of property developers with good quality and credit.

Our view

Asian Bonds

In combination with the relaxation of home purchase restrictions in 42 out of 46 cities, these measures should help to support a recovery in demand and improve sentiment towards the overall property market. However, it may take some time before we see a meaningful turnaround in the
market, given the current large stock of unsold inventory and still sizeable levels of housing under construction. As a result, we remain cautious on the Chinese property market as a whole, and we expect volatility in Chinese property bonds to continue in the near term.

Notwithstanding, we believe the risk/return profile of selective Chinese property bonds issued in the offshore market provides attractive investments for investors seeking higher yield and who are able to withstand bouts of volatility. For longer-term investors in bonds, periods of volatility should be less of a concern as long as default risk is managed through a fundamentally-driven security selection approach. With an average yield of around 7% and 9% for BB and single B-rated Chinese property developers respectively, and a relatively low average duration of about four years, selective bonds offer attractive opportunities. Our focus is on the larger, better quality and more diversified players that have a relatively sound balance sheet with lower leverage. We look for issuers that have good access to funding, financial flexibility and strong sales execution capabilities. These developers should benefit from further consolidation of China’s property market and any recovery of demand ahead driven by the mortgage relaxation measures.

China’s Equities and A Shares

We believe the relaxation of mortgage restrictions should help the sentiment and the transaction volumes in the physical property market in the short term. The chances of a full-blown crisis is still remote, nonetheless there is still a lot of corporate pain to be felt. There are almost 60,000 property developers across China, many of which sprang up in the heady environment of cheap credit, so further defaults amongst smaller, unlisted developers are almost certain. The listed property sector is generally more robust, but net asset values (NAVs) will fall further and we can expect to see rising capitals to shore up balance sheets through this difficult period.

Although we see this as a cyclical correction, we also believe that the recovery will be far less robust than after previous corrections. A few years of slower construction are needed both to clear inventory that has been built up and to re-align annual supply and demand. As a whole, we remain cautious on the property sector albeit likely to have a rebound in share price for the short term.

Appendix: Chinese property developers

There are an estimated 60,000 property developers in China, of which only around 50 have issued offshore bonds in the Asian USD bond market. The majority of these issuers are rated by either Moody’s or Standard & Poor’s with around 10 rated as investment grade, whilst the remaining 40 are non-investment grade. Typically, only the larger and better quality property developers are able to issue bonds in the USD bond market given the more stringent reporting requirements and the greater scrutiny by international investors (including being rated by international ratings agencies), which are the key buyers of these bonds (as opposed to domestic buyers). Whilst there are some weaker issuers in this space, on a whole, we view that default risk is more of a concern in China’s onshore bond market as opposed to bonds issued in the offshore USD bond market. This is because the credit profiles of these larger nationwide developers are by and large, manageable given the lack of a major cash-flow burden in the near future, as they have been proactively managing their balance sheet liquidity by slowing down construction and acquisitions of new land. Many have also taken advantage of the strong capital market earlier this year to refinance and extend their major debt maturities that helped to underpin their liquidity positions.
Market Insights - China relaxes mortgage lending rules

JPM Asia Credit Index (JACI) – Non Investment Grade Index, by market cap (%)

- Chinese Property Developers: 26.9%
- Other: 73.1%

Source: JP Morgan, Allianz Global Investors, as at September 2014.

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