There are tens of millions of empty new-build apartments in China's newest "ghost cities" (see picture below). A Chinese real estate developer with 3.5 billion yuan ($566.6 million) of debt recently collapsed and its largest shareholder was detained. The developers of a large residential complex in Nanjing held a long-jump contest for queues of potential buyers. The further you jumped, the more of a discount offered on your new home. **All signs point to China's meteoric property boom turning to bust and we believe that the bubble is already bursting.** What impact will this have on the world's second biggest economy and should investors be worried about the knock-on effect elsewhere?

Over the last decade, China's largely rural population has embarked on a state-initiated mass migration from farmland to city. The move created enormous, government-sponsored demand for residential property and developers gorged themselves on plentiful, cheap credit from the shadow banking sector in order to meet this demand for new housing. **No wonder then that over a 2-year period China produced more cement than the US produced in the whole of the 20th century** (US Geological survey and China's National Bureau of Statistics). Adding fuel to the fire, the Chinese authorities recently published a long awaited and widely anticipated plan to further grow its cities over the coming years. The proposal? To move an additional 100 million people into urban areas by 2020. In order to hit this ambitious target, a huge infrastructure drive will be required over a number of years, from rail projects to schools, hospitals and housing. But **the Chinese domestic buyer has become increasingly nervous about falling property prices, whilst the politburo has started to tighten borrowing limits** and rein in the shadow banking sector. Investors are therefore wondering how this ambitious expansion programme is going to be funded and who is going to buy all of this newly proposed supply.

It is now feared that growth may at last be starting to slow in China after a decade of near double digit annualised GDP increases. Almost all economic growth indicators for China in April were negative and recently the outlook for Chinese property has been particularly poor. Real estate sales have fallen over 7% and the volume of new construction projects fell more than 16% compared with a year earlier. **But is the slowing economy causing the property market to cool or vice versa?**

Many analysts believe that oversupply of property is the major drag and that domestic investment in Chinese real estate is the single most important driver of the Chinese economy. **Over the last few years Chinese developers have relied on plentiful, cheap credit** supplied by the increasingly leveraged shadow banking sector….

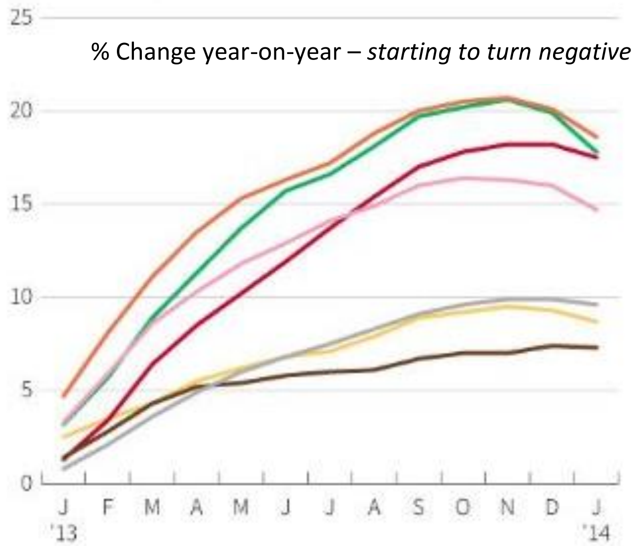
One of China's many "ghost cities"

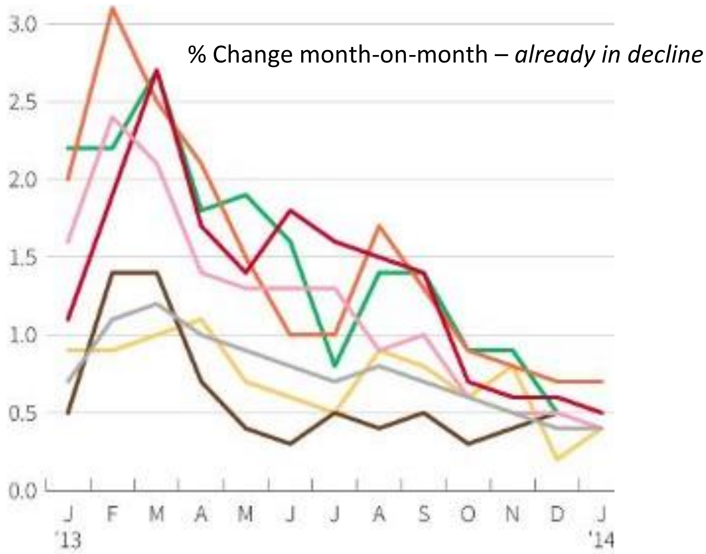
….**using land as collateral** for such loans on the expectation that prices will continue to rise. This all sounds too familiar.

Property and related spending (furnishings and "fit-outs") accounts for between 16 and 23 per cent of Chinese gross domestic product depending on who you believe and at the top end this is higher than the US, Spain or Ireland at the very peak of their respective housing markets. **New housing construction plunged in the Q1 of 2014** and property sales declined too in 2013. **Such headlines do not auger well** given what we now know about the impact on western economies during the credit crunch in 2008, which was triggered by the collapse of the property market in the US.

As we know, the **supply of cheap credit (which has reached an eye watering $25tn in China) cannot continue indefinitely**. As mentioned above, the Chinese authorities have started to tighten lending criteria and restrict further borrowing. This could, if not carefully controlled and managed, lead to a further slump in Chinese property in the coming months.

Average new home price changes in various major Chinese cities since Jan 2013….
Source: Reuters





In fact, this tightening action has already resulted in unsold commercial and residential property hitting an all-time record in March 2014.

A slump in property development in China will have a direct impact both domestically and internationally. **Land sales have fallen by 22%** and the government relies on these land sales and taxes on property for more than a third of their total tax revenues. Also, amongst the country's middle and upper classes, **a sustained property slump will have a dramatic impact because wealthy individuals** have had very few other places to park their growing fortune due to tightly controlled financial markets**. In addition, a reduction in domestic Chinese property development will have a dramatic effect on the prices of commodities** used in construction, such as iron ore.

The Chinese authorities are already well aware of the situation but seem reluctant to intervene for the time being, preferring to focus instead on slowly turning the screw on the fast, loose and profligate lending practices of the shadow banking. This is a show of force from president Xi Jinping and, along with allowing the very public default of several corporate bonds for the first time in recent history, this is a very clear shot across the bows of current and potential credit cowboys. However well-intentioned and justifiable this action is, it comes at the cost of **risking an escalating property slump that could drag down the Chinese economy.** Mr Jinping will need to be conscious of the property market reaching a possible tipping point and they will need to move quickly before the property crisis gets out of hand. It's a balancing act even more difficult than that facing our own central bank governor.

However, it would be foolish to make sweeping generalisations about the property market in China across regions, in much the same way as it is a mistake to judge the UK property market on the success of London alone. The bigger, more developed cities such as Beijing and Shanghai are still facing large net-inflows of migrants and require additional development, whereas the medium sized cities (which between them account for about a third of all construction projects in China) have suffered the most from chronic over supply and as a result have experienced the largest decline in prices.

Prices for **top-tier properties in Beijing and Shanghai have now started to eclipse London, New York and Hong Kong** and the country's most influential property developers seem to agree that things have gotten out of hand. According to the China Post, Mao Daqing the vice-president of Vanke (China's largest property developer) was quoted saying that "Multiple pieces of evidence suggest that the Chinese property market in 2013 shared many characteristics with that of Japan and Hong Kong before the bursts of their asset bubbles" and that "….the rapid growth in Beijing and Shanghai is approaching Tokyo and Hong Kong levels before they went bust". Mr Mao seems to be the epitome of a turkey voting for Christmas and this is troubling.

The key consideration must be whether or not the Chinese politburo has enough of a handle on the situation to carefully control the slowdown and whether the levers available at their….

Chinese GDP growth is looking a little tired….

Source : The Economist

….disposal are powerful enough to turn things around if the crisis escalates.

As we've suggested in previous updates, **we believe that the Chinese are the best placed of any of the global superpowers to act quickly and decisively at home**, as they have a long term mandate and a vast amount of foreign currency reserves at their disposal, mainly in the form of US treasury bonds. If needs be they will sell down some of these reserves to prop up failed lenders and property developers and they have greater power therefore to ensure that this crisis does not become China's own version of the 2008 credit crunch, although this might be bad news for owners of US treasuries.

All else being equal, the longer term effects of this profound slowdown in the Chinese property market are unpredictable at present and **we feel that it is sensible to remain underweight to Chinese equities and currency**. If the deflating property sector is mismanaged this will create real risk of further slowdown in Chinese GDP and this in turn could damage sentiment for the equity markets. Even if we are wrong about property in China, growth might continue to slow anyway due to an overburdened shadow banking sector and an oversupply of credit.

Investors who believe that Chinese GDP growth might actually recover may be better served investing in Japanese equities instead, which have shown significant correlation with China over the last six months but without the same domestic issues. Considering the relative current economic prospects of these two best-of-enemies and neighbours, **Japan has emerged from its long term deflationary spiral and seems to be on track for more consistent growth** and at last some inflation, despite a hike in the dreaded sales tax that was so feared by investors the world over. **Meanwhile China's growth is slowing** and they are caught between a property bubble and a credit crunch, with policy makers damned if they do and damned if they don't.

Therefore we'd rather invest in Japan than China at the moment and have positioned our clients' portfolios accordingly.