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WEBINAR SUMMARY

China Deleveraging, Defaults, Deflation—Capitalizing on Opportunities and Navigating Risks

Fears are mounting around China's property crisis, deflationary pressures, and faltering confidence. Investment professionals from T. Rowe Price's Fixed Income Division shared their comments on how to navigate opportunities in Asia Credit amid a slower economic growth in China.

What's been happening in China?

Sentiment towards China turned bearish recently, with a worsening property crisis and fresh signs of banking sector stress adding to worries about an economy facing deflation. Most notably, liquidity troubles in the real estate sector have attracted the most headlines after Country Garden, once the country's largest private developers by sales, missed coupon payments on two of its US dollar bonds. The company subsequently warned that it will post net losses for the first half of 2023 and halted trading on 11 of its onshore bonds, heightening concerns about potential contagion effects. Meanwhile, there was renewed focus on the "shadow" banking industry after trust company Zhongrong International Trust reportedly suspended payouts on several wealth products.

The flurry of negative developments has occurred against a backdrop of a slowing Chinese economy. Optimism about the post-reopening bounce quickly faded as economic indicators began to lose momentum. Housing sales dropped below their 2022 levels, while spending on consumer durables and services moderated as well. There were also export headwinds amid softer demand for goods globally. Weakening credit indicators further highlighted the subdued demand environment domestically.

What are the prospects for Country Garden and the property sector? How do you think policymakers will respond?

Country Garden has a 30-day grace period to make its missed payments. However, given its weaker liquidity position, we believe there is a high chance of a default in the coming months as it faces chunky debt maturities. This would certainly weigh on an already-weak physical market. Country Garden currently has more than 3,000 projects nationwide, and the likely increase in unfinished developments if it defaults will further depress homebuying appetite. Meanwhile, bond prices across the property sector, especially those of surviving privately-owned developers, may suffer collateral damage.

We believe policymakers will stay reactive. Recent policy responses have been incremental, such as the modest relaxation of homebuying curbs and reductions in downpayment rates. These measures could be helpful in the short-term but might not be sustainable. However, we doubt the authorities will take more meaningful action in order to avoid reflating the housing market.

From a fixed income investor's perspective, we think developers with ample land banks in higher-tiered cities are better positioned to survive the turmoil as well as issuers with manageable near-term debt, alongside those with investment properties that can generate rental income or overseas assets to cushion against the domestic downturn. That said, over the longer-term, we believe China's property sector will undergo a multi-year structural decline due to multiple factors, including a shrinking population, slower urbanization, changes in family formation, and the construction industry's switch to a more utilitarian model where state-owned developers are more prominent.

Do you think the recent issues in the Trust sector are reflective of more systemic financial risks?

The Zhongrong Trust episode highlights how the real estate downturn could potentially drive asset quality problems in other parts of the financial sector. However, we do not believe it represents a systemic risk to the system as a whole.

It is worth noting that the trust industry is only a modest part of China's overall financial system. Considered in its entirety, the bulk of the banking sector's exposure to the property sector is through mortgages, rather than loans to developers, and we have not observed signs that household mortgages are under stress. Further, trusts are more likely to extend loans to riskier borrowers, and therefore are more likely to feel the tremors of asset quality stress earlier than other financial institutions.

Moreover, Beijing has increased oversight over the trust industry since 2015 with a wave of regulations. Hence, regulators have developed experience in dealing with several troubled financial institutions on a case-by-case basis and have made timely interventions to ensure that spillover effects are contained.

What is your outlook for the Chinese economy and markets for the rest of the year?

While Beijing's deleveraging may continue to pressure growth, we do not think China will fall into an outright debt crisis or a "balance sheet recession". End-borrowers are not facing debt servicing constraints, while interest rate cuts are keeping mortgage and local government debt sustainable.

On the policy front, policymakers seem to recognize the need for more stimulus. Already, we are starting to see some policies being rolled out. However, they remain largely incremental as opposed to the "big bang" stimulus actions of past cycles, and it is unclear if that will be adequate to restore confidence. In particular, the central bank has cut key policy rates and reserve requirements, keeping markets relatively flush with liquidity. Additional rate cuts, as well as more fiscal spending, will probably be needed to support the economy. Ultimately, we believe the authorities will be reactive, and will step up policy actions should the economic data diverge excessively from the growth targets.

Turning to credit markets, we think Chinese local currency government bonds appear attractive, with yields expected to remain low or fall further as the People's Bank of China continues to cut rates. Meanwhile, we still find interesting, idiosyncratic opportunities within the Chinese credit space, using our bottom-up approach. While property remains challenging, we expect sectors such as consumer staples, hardware technology, and logistics to remain resilient. Careful credit selection with a focus on fundamentals remains crucial to navigating the volatile and uncertain environment.

What are the implications of a slowing China for the rest of Asia or the world?

China's slower growth will undoubtedly have repercussions beyond its borders, but the impact may be varied in view of the structural changes taking place.

In general, countries exposed to China as an end market are either commodity exporters or capital goods manufacturers. In commodities, producers of materials tied to housing construction may face prolonged pressure as the housing boom ends. But the shift towards green energy potentially opens up opportunities for exporters of metals needed for the buildout of such technologies and infrastructure, such as those from Indonesia, South Africa and Latin America. As for capital goods, the ramp up of China's electric vehicle and auto-making capabilities reflects how it has moved up the production value chain. Consequently, this could lead to some displacement of goods that it traditionally imported from other parts of the world. Conversely, China may start importing more lower-value-added consumer goods that are increasingly being produced in other Asian countries with lower labor costs.

In summary, the trends we see today are not just the result of moderating end-demand from China. Rather, shifting patterns of trade and development will have nuanced and differential effects across Asia and the broader emerging markets. There will be clear winners and losers, requiring investors to employ deep fundamental research, a highly selective approach and active management to navigate the risks and capitalize on opportunities.

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