Focus on China's uncertain construction sector

October's growth in industrial production, investment and retail sales was very mixed. Sudden electricity outages will probably not re-occur. But questions remain about real estate policies and the unexplained sluggishness of infrastructure investment and the outlook for 2022

People watch the semiconductor products exhibited at the 2020 World Semiconductor Conference in Nanjing city, east China's Jiangsu province

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Activity slowed in October as expected

Despite a few days of electricity outages, rapid increases in mining resulted in industrial production growth of 3.5%YoY in October, up from 3.1%YoY in September.

Fixed asset investment slowed to 6.1% YoY YTD in October from 7.3% a month ago for several reasons. These included tight funding for real estate development, and also control of government debt. Put another way, the bond coupon rate was too high for some local governments to raise funds from the market for their infrastructure projects. The main bright spot remained investment in advanced technology.

Retail sales grew 4.9%YoY in October from 4.4%YoY in September. October is traditionally part of the "spending season" as it contains a long holiday. The amount of spending should be similar to that accompanying the long holiday in May. But just like this May, people tended not to undertake cross-province travel, since the risk of being locked down while away from home rose as Covid cases began to increase. But people still spent money on local travel, catering and jewellery.

Generally, the October activity data was not as bad as expected.

Stable growth for the coming months

We believe that there will be some moderation of current restructuring policies, and we do not expect any new policies to be introduced that will further rein in business activity. But the main factor that will change in November is the end of sudden electricity outages.

The number of Covid cases is rising, although it is still at a very low level currently at only about 100 daily new confirmed cases. But the potential for sudden strict domestic travel restrictions means that people are still very hesitant about travel. This could continue into the coming Chinese New Year holiday in February 2022. We expect retail sales to be affected, but savings from train and plane tickets will likely be spent elsewhere. For instance, on clothing, catering, cinemas, etc.

Focus on China's construction activities

There is mounting concern that China's construction activity will slow down rapidly in 2022. We don't share this view. The key factor to keep in mind is that property investment growth is still 1.1 percentage points faster than headline fixed-asset investment growth. This indicates clearly that the real estate sector has not slumped even if there has been a lot of negative news in the market.

1 Real estate property projects

Regarding real estate property projects, we should see continued activity on uncompleted projects. These are the cash cows for real estate developers. With more cash, they can meet maturing bond payments. Operating expenses are likely to come from the divestment of some of the developers' assets. The critical component here is the selling price. October's new home prices edged down 0.25% from the previous month. This is a very small drop compared to the high credit costs in the bond market. Some local governments have issued measures to stabilise home prices, including setting a price floor, which essentially stops home prices from falling.

On new starts, we expect to see state developers increasingly winning land bidding auctions. Private developers may not have enough cash to bid for land. In a few years, the landscape of the real estate sector should change from being dominated by privately-owned companies to looking much more balanced between the private and state-owned sectors. It is not clear if we will see new construction starts in 2022 retreat from 2021 levels.

There are also concerns that real estate developers are going to default and construction activity will stop. But we think this concern may be overdone.

Divestment from real estate developers has started, so cash flow should become healthier. Those divested assets will mostly be in industries unrelated to real estate. Following these divestments, some conglomerate style developers will again specialise mainly in real estate development.

Even in the event of some firms being on the brink of going bust, mergers and acquisitions should help uncompleted projects to finish. Again, the acquirers are more likely to be state-backed.

2 Infrastructure construction

Infrastructure construction has slowed since the third quarter of 2021. One of the reasons for this is that local governments have faced higher interest costs when issuing bonds to fund infrastructure projects. As China's credit market calms down, local government funding should start to normalise, and local governments should be able to start funding infrastructure projects again on transport, renewable energy, advanced technology and the 5G network.

3 A cleaner construction sector

One concern about construction is that it is polluting. But a pilot for carbon trading for industry participants is now underway in China. Although this is unlikely to cover all of the pollution generated by construction activity, it is a step in the right direction.

Another solution to address pollution comes from the central bank. The PBoC has offered cheap loans to banks to encourage them to undertake more green lending. We expect some of these loans to be taken up by infrastructure developers where there is a clear objective to directly reduce carbon emissions (e.g. renewable energy projects). Some real estate developers have also been able to issue green bonds.

As of November 14th 2021, there were over $68 billion green bonds issued in 2021 in China (by country of risk). The coupons of green bonds issued by real estate developers averaged 6.35% while those of renewable energy averaged 2.925%.

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