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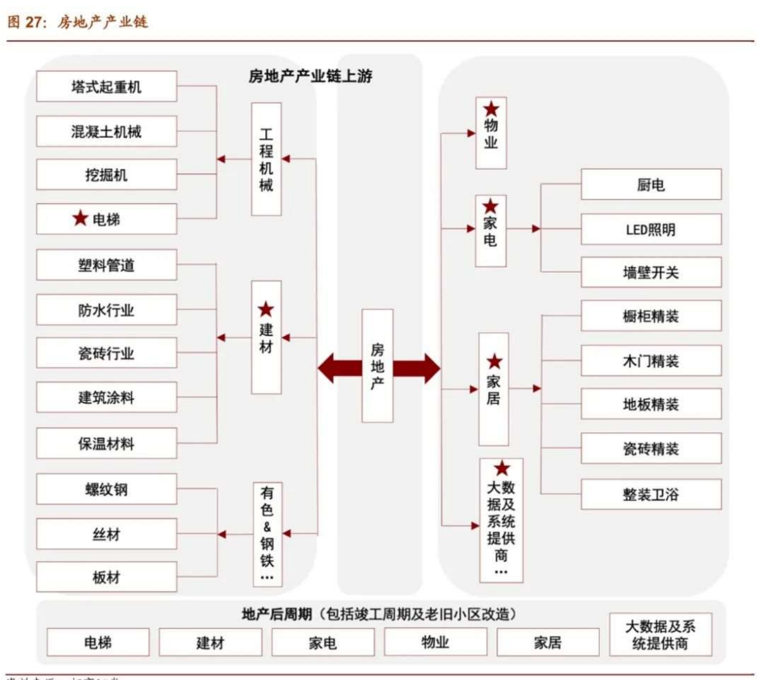
When the Market Beta Changes

In China's capital market, the changing fortunes of the stock market may impact some investors, but the sector that truly change people's fate is the real estate market, a market that's facing a dramatic change. Throughout 30 years of China's economic reforms, real estate sector had a star role. The entire value chain affected dozens of affiliated industries, employed over 30 million people, accounted for almost 30% of China's GDP. Over 60% of China's household wealth is in real estate, where the total market value is estimated to be 400 trillion RMB. China's real estate market is huge by any measure.



Source: China Merchant Securities. Various industry chains related to Real Estate.

Real Estate sector can be residential, financial, and investable at the same time, becoming a unique driving force for China's economy like no other. The last few decades' big housing cycle and tremendous urbanization transformation have set the stage for the real estate sector to shine. A whole generation rode on the real estate express and achieved life-long dreams. Here's a joke told by a seasoned investor: rather than getting a job at the best company ten years ago, you're better off just buying an apartment next to the best company ten years ago. Indeed, Real Estate sector was the market beta. The key to success is not how fast you paddle, but rather which boat you are on.

Things, however, are changing. When the government emphasized that housing is for living, not for speculating, we can see the shift. With more restrictive regulation and tighter monitoring, real estate investment is coming back down to earth. The sector's financial or investable attributes are gradually taken away, until it becomes just the house to live in. As one cycle closes, another will open. Who will be the lead on the next investment cycle? Where is the market's beta now? What can become the new growth engine for the Chinese economy? Which sector will be the darling for the investors and help the household wealth to grow? These are the questions we'll attempt to answer below.

1. The 20-year Real Estate Cycle

In Jan 1980, government publication "Red Flag" had an article "how to solve housing problems more quickly?" In the article, the authors suggested that housing is an important component of personal consumption, and should be commercialized. Up till then, housing was seen as a fringe benefit allocated by the hiring company. The debate went on until July 1998, when the housing reform went ahead and commercialized the housing market, thereby launching the great cycle of Chinese Real Estate. In the 20 plus years since then, the real estate prices have risen consistently, with total housing market value estimated at 476 trillion RMB. It grew at annualized 15% in the last six years.

The real estate's characteristics are also changing as the housing prices and people's perception changed. When the housing prices jumped up, it changed from a simple residential place to an investable product. Back in the 1990's, the hottest item was the housing-future from Hainan province. In the 2000, the best-known groups are those housing-purchasers from Wenzhou that literally buy hundreds of apartments in a single visit. By the time 2010 comes around, nobody wants to be left behind. Families pooled all their resources to jump on the real estate train, a clear example of FOMO. In the "China Wealth Report 2022", it's estimated that real estate account for over 60% of total household asset, and is by far the most important asset for the average household.

Real estate sector is involved in the monetary policy dissemination mechanism. There are four chains where real estate is linked to. The first chain is from PBOC to real estate developers. When there's loose monetary policy, PBOC can increase available funds to developers via lower RRR or lower LPR; developers can use land bank for collateral to gain more financing from banks; and capital can go down the chain as real estate links up with cement, steel, machinery, and other areas. The second chain is more complicated and involves the funding along the development cycle, including initial credit facility when

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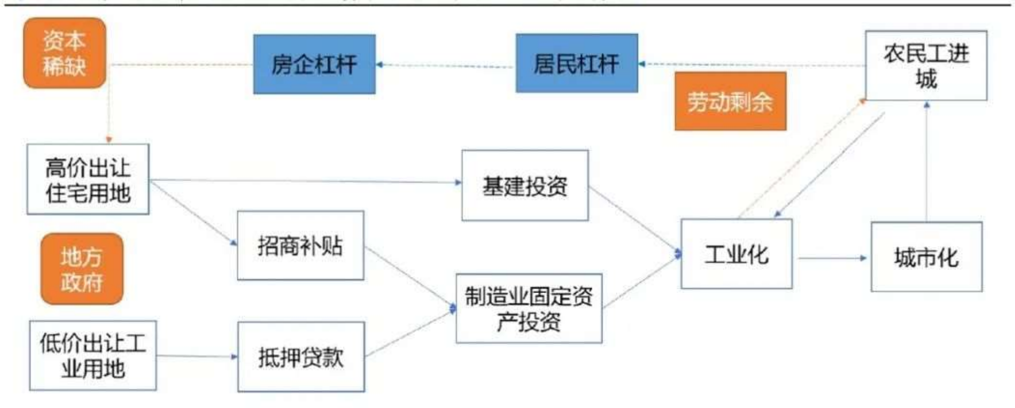
purchasing the land, the trust account during the development phase, and the commercial management and supply chain financing near completion. The 3rd chain is where households take out housing loans from banks with housing as collateral. The household savings therefore is utilized, while their debt also increases, mostly into the real estate market. Once the house is purchased, the renovation and new housing appliances impacts the downstream application and furniture suppliers. The last chain involves how local government uses the land sale proceeds to build infrastructure and attract capital investments to increase urbanization and improve living conditions. These four chains collectively form an investment to consumption loop, which can see ten of trillions of RMB of funding to flow from banks to the real economy, thereby achieving the monetary policy transmission target.

图 40：地产为经济及地方政府提供资本，从而推动工业化和城镇化



数据来源：国泰君安证券研究

Source: Gutaijunan Securities research.

As the triangular relationship among Real Estate – Government – Indirect Financing forms, Chinese economy grew quickly along with household wealth. At the same time, the pressure to buy a house also increases. It used to take 10 years for one person to save up to buy an apartment, and then it takes one person a lifetime's earnings to buy an apartment. Now, it takes collective savings of three generations to buy an apartment. Looking back, it started in 2016 with the "living, not speculating" housing slogan, then the 2018 asset management rules that forbid shadow non-standard funding for housing projects, and the 2020 "three red lines" policies that required ex-down-payment debt ratio of under 70%, net debt ratio of under 100%, and cash to short-term debt ratio more than 100%. One of the key characteristics of the real estate market in China for the past 20 years was high leverage and fast cycling of liquidity. The "three red lines" policy directly challenged the core feature of the industry, forcing real estate into a state of huge adjustment. Who can be the next torch-bearer? Where is the new market beta?

2. Who is the next economic growth engine?

The most important question in investment is to know where we are in the market cycle. The next important thing is to adjust our investment expectations according to the market cycle. Before we discuss who the next torch-bearer is, we have to recognize that it's extremely difficult for a single

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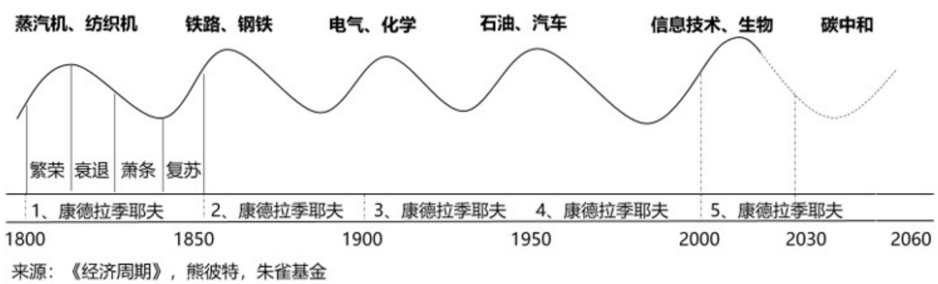
industry to carry 30% of GDP like real estate did. With real estate softening and the de-globalization waves, the previous growth sectors of consumption, investment, and export are all lacking power. To the Chinese economy, this means a slowing growth rate is likely the long trend. The old triangle of Real Estate – Government – Indirect Financing" will become history, while the new triangle of "tech innovation – industry – direct financing" will replace it. We saw this transition happened in Japan. In the 1990's, after Japanese real estate bubble busted. Many households and enterprises had negative equity, monetary policy became ineffective, and a lost decade ensued. In our opinion, the main reason Japan lost the 20 years is because it missed almost the entire information revolution.



Source: Economic Cycle, Joseph Schumpeter, Rosefinch.

The 90s were the birth-decade of information revolution. All of the internet giants had their first steps in the late 90s and early 21st century. Japan though, remained a manufacturing base. Even till now, people recognize Japanese companies that came to world stage via car-manufacturing or consumer electronics back in the 70s and 80s. Aside from Son's Yahoo, Japan almost had missed the huge internet cycle entirely. The Japanese experience showed clearly choosing the right industry is more important than working hard. The consequence of missing the market industry opportunity is far more severe and long-lasting than making an industry-specific decision.

Just like the real estate in the 90s and the subsequent information technology revolution, market is now coming to another pivotal point where a new round of technological revolution is emerging: carbon-neutrality. Carbon-neutrality has become the biggest common denominator amongst the global economies. This worldwide energy complex revolution is a huge shift from energy sector to the manufacturing sector. Across coal, oil, gas, photovoltaic, BIPV, energy storage, hydrogen industries, this is a multi-ten-trillion USD opportunity. And this time, China is already leading at the forefront of some of these sectors: China is the world's largest solar panel exporter, with over 70% of the photovoltaic equipment manufacturing capacity. Another sector that's fast growing is new energy vehicles. China's new energy vehicle sales has ranked #1 globally for 7 straight years, with over 20% market penetration. In the subsequent "smart car" and the even broader intelligent-connectivity-of-everything, there will be huge market opportunities.

Some people may say: photovoltaic and new energy vehicle markets in China were propped up by government subsidies. In fact, when Japan couldn't stimulate consumption, China government could take on the public debt first, and stimulate private consumption. This is simply another way of deploying fiscal stimulus. Government investment won't be the deciding factor for the Carbon-reduction related industries. Any new industry will need some government support. Even the most market-driven internet industry had its start on back of vast government-built infrastructure and tax incentives. In summary, we can remain optimistic even as the real estate sector slows – those capital and talents released from real estate can be redeployed and reborn in the new industries.

3. Where can private assets go?

The market beta is changing, so the private investors must close the old playbook and look beyond the real estate investments. To an individual investor, a high-quality mutual fund may be one of the best investment choices. The public mutual funds were created as a benefit for the investors' retirement funds. The recent policy guidance to promote more personal retirement asset into mutual fund investment is one such example.

Between 2007 to 2021, China's M2 grew an annualized 12%, which was roughly in line with the housing price increases in Beijing/Shanghai/Shenzhen. In that same period, the equity mutual fund index's annualized return was 15%, i.e. faster than both! Having said that, because many people bought houses with leverage, their return on investment from housing would be much higher. If someone only pay 30% and borrow the rest, and housing price goes up 15%, then they have achieved a return of 50% (ignoring taxes and various transaction costs.) Housing loan is the most massive leverage for an average household. In those high-growth years, there was relatively little risk. Real estate investing was the biggest opportunity for the average household. But people usually only recognize the market beta when it's already passed.

The age of carbon-reduction is here, and the market beta is shifting. As we said before: it's not about how fast you paddle, but which boat you are on? The vessel of carbon-reduction is sailing away, are you ready?