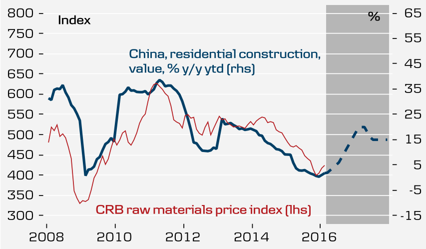
31 March 2016

Research China

A turn in construction to be a game changer

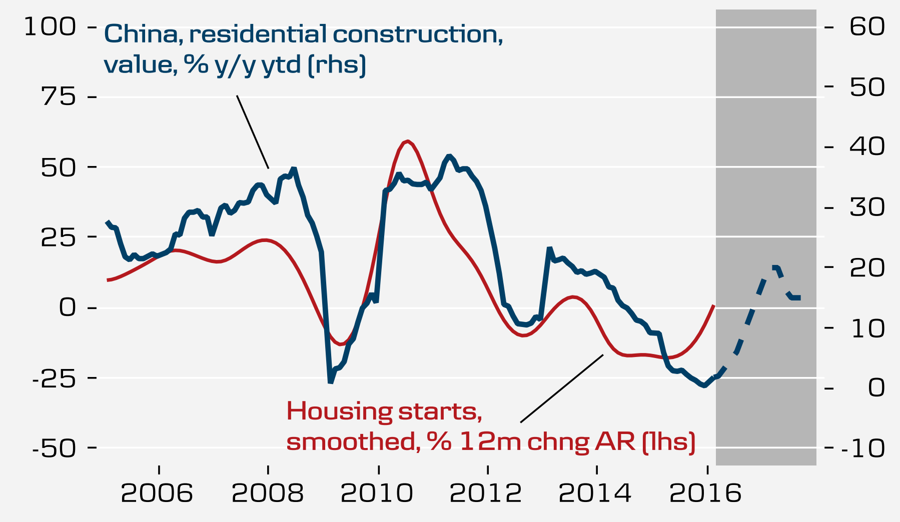
- **The hard landing in Chinese construction looks set to be ending. We look for a gradual recovery of the construction sector over the next year.**
- **The sharp slowdown in construction has been a heavy drain on China's economy and global commodity markets over the past two years. A recovery of this sector could prove an important game changer for industries, countries and markets exposed to Chinese construction.**
- **It would thus give support to Chinese equities and global risk sentiment, as it reduces the risk of an overall hard landing in China.**
- **Global commodity markets and commodity exporters is also to benefit. China consumes around half of most base metals in the world and is a major driver of iron ore, copper and other raw materials.**
- **A rise in commodity demand would in turn give relief to commodity-exporting emerging market countries such as Brazil and Chile and benefit Australia's exports of iron ore. It would also dampen deflationary pressure in China - and globally. Easing deflation fears will underpin higher bond yields during 2016.**
- **Finally, a recovery in the construction sector would alleviate some of China's challenges with overcapacity in the steel, cement, aluminium and glass sectors and support Chinese developers. These are the areas where the majority of non-performing loans are centred. Hence, a turn in construction would work to dampen the rise of non-performing loans and alleviate the pressure on banks.**

Chart 1. A recovery in China would support commodity prices



Note: Grey area is forecast
Source: Macrobond Financial, Danske Bank

Chart 2. Hard landing in Chinese construction coming to an end



Note; Grey area is forecast
Source: Macrobond Financial, Danske Bank

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Significance of the Chinese construction sector is overlooked

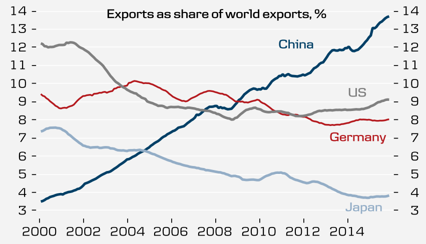
In many ways, the importance of the hard landing in Chinese construction has been overlooked as a major driver of today's economic challenges in both China and the rest of the world. A lot of focus has been given to China's export slowdown and the fear of a devaluation has been at the centre of market attention. However, China is still gaining market share on global export markets and there is no sign Chinese competitiveness is at the core of China's problems. The fall in export growth is an effect of a stagnation in global trade and not a loss of market share.

Instead, **the slowdown in construction has been at the core of China's growth problems.** We estimate that the Chinese construction sector drives around one-third of economic activity in China. This includes both the direct effects of construction investment (around 15% of GDP) and the indirect effects on suppliers and industries that produce steel, cement, aluminium and so on, which goes into construction. China also consumes around 50% of the world's steel, aluminium, copper, zinc and other metals and a lot of this demand originates from the construction sector.

With this in mind, it should be no surprise that **the fall in the growth of Chinese construction investment from 35% in 2011 to 0% in Q3 15 has been a major driver of the slowdown of the Chinese economy** – with the negative spillover to global commodity markets and commodity-exporting countries such as Brazil, Chile and South Africa.

While robust service sector growth has secured a soft landing for the overall Chinese economy, the significant slowdown in construction and industry means it has largely been **felt as a hard landing for the rest of the world. However, this could very well be coming to an end.**

Chart 3: Exports not the problem – China is still gaining market share



Source: Macrobond Financial, IMF, Danske Bank

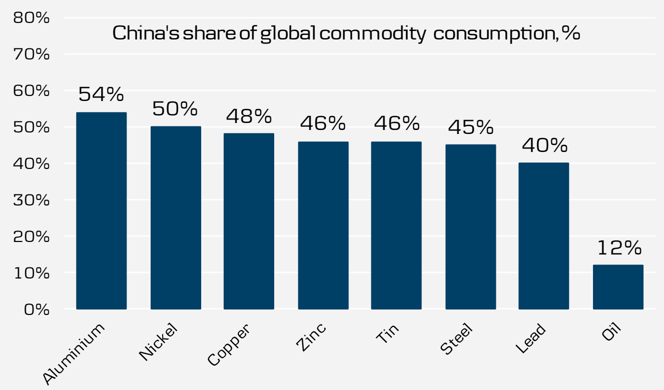
Why did China hit a hard landing in construction?

The reason for China's hard landing is fairly simple: China overinvested significantly in new houses. While it can be discussed whether China has a bubble in house prices – because it depends on future household income growth – there is no doubt in our minds that China experienced a bubble in housing investment. **A building boom took place in 2010-13 and when home sales suddenly fell sharply in 2012 (in response to rate increases by the PBoC), the construction sector hit the wall.** The picture of ghost towns in China are well known and while the high urbanisation rate helps China fill up empty cities, the oversupply simply became too big.

Chart 4. Overall economy has not seen a hard landing. but the industry and construction sector has

Source: Macrobond Financial, Danske Bank

Chart 5. China consumes a large chunk of global commodities



Source: World Economic Forum, Danske Bank

It should also be noted that the pattern is very diverse across regions in China. The problem with oversupply is biggest in so-called Tier 3 and 4 cities (centred mostly inside China), while Tier 1 cities such as Beijing and Shanghai continue to suffer from undersupply, which is feeding continued sharp price increases in these cities (this could cause problems further down the road).

Why should Chinese construction recover this year?

The reason construction should recover is that **the oversupply of houses is coming down as (a) home sales have picked up and (b) housing starts have declined since 2012.**

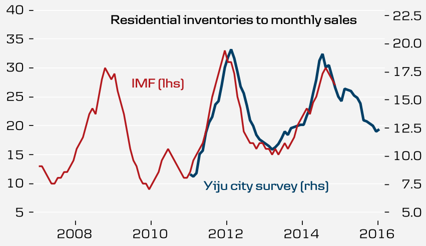
First, let us look at home sales. As Chart 7 shows, home sales picked up at the beginning of 2015 and overall sales were up 15% for the whole year. **China has aimed a series of stimulus measures at boosting the turnover of houses to deal with the oversupply** and pave the way for a recovery in the construction sector.

1. **Rate cuts:** Since November 2014, China has cut the lending rate six times – partly to secure cheaper home financing. This has led to a big fall in mortgage rates. Chart 8 shows the clear link between bond yields and home sales (in the chart we use government bond yields, as the history of our series for mortgage rates is not very long). The relationship is quite clear. Lower bond yields feed into home sales with a lag of nine to 12 months. This also means last year's rate cuts should increasingly feed into robust home sales this year. We look for further rate cuts over the next six months to add stimulus to housing.

2. **Reduction of down payment for house buyers:** On top of policy rates, China is very active in using the requirement for down payments for house buyers to manage the housing market. In September 2015, China cut the requirement for first-time homebuyers from 30% to 25%. In February this year, it reduced the rate again – from 25% to 20%. With a lower down payment required, it takes a lot less savings to be able to buy a home and thus widens the group of possible homebuyers.

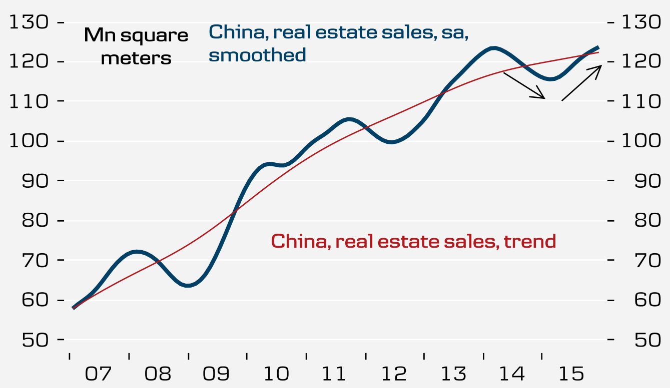
3. **Ease Hukou system to speed up urbanisation:** The last measure China has increasingly focused on to fill empty houses is relaxing the so-called Hukou system, a household registration system. Many social rights can be used only in the area where a Chinese household is registered. This is one reason China has an estimated 150-200m migrant workers who leave their home city to work in the big cities and then send money back to the family. Easing the Hukou system would make it possible for more of people to move their families with them to the cities and this would increase the demand for housing.

Chart 6. China's oversupply of houses is coming down



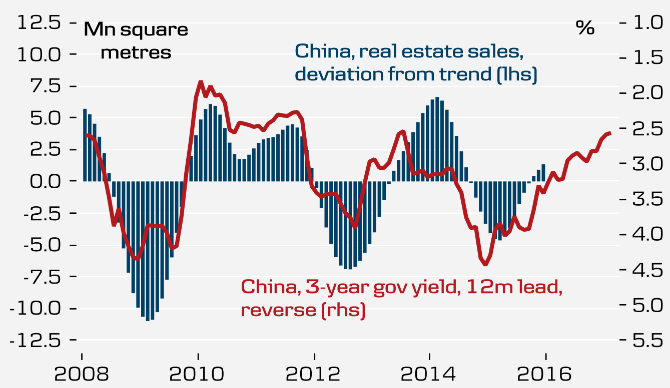
Source: Macrobond Financial, Danske Bank

Chart 7. Chinese home sales recovered in 2015



Source: Macrobond Financial, Danske Bank

Chart 8. Monetary policy easing feed through to higher home sales – more to come over the next year



Source: Macrobond Financial, Danske Bank

The already high urbanisation rate is helping to keep home sales at a high level. Over the past 10 years, around 20 million people have moved from rural areas to the cities. This corresponds to 55,000 people per day, which makes it easier to fill empty houses and cities. This high rate of urbanisation is a normal pattern in economies that are catching up. A similar pattern was seen in Japan after WWII and in the Asian tiger economies from the 1960s as they caught up with the West. In China, 55% of the population now lives in cities, up from 20% in 1980. However, once a country is fully developed, the normal urbanisation rate is around 75-80%. This leaves scope for another 20% of the population to move to the cities over coming decades, which equates to 270m people – this is close to the size of the entire US population.

As home sales have picked up, the oversupply of houses has come down and on average is not far from the long-term average level (see Chart 6). Hence, a construction recovery is on the cards this year and is a central part behind our expectation that the Chinese economy will get better. However, the timing has been uncertain, as it has been unclear how quickly the oversupply of houses would come down. However, there are many signs that we are now at the inflection point and construction is starting to recover from weak levels.

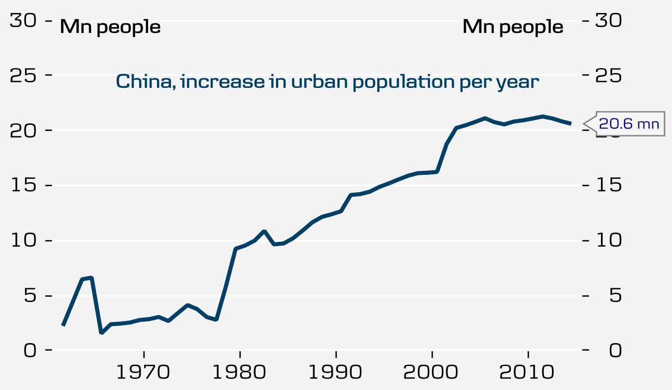
One sign is that growth in residential construction investment increased in both January and February this year, for the first time in three years**.** Another sign is that housing starts also improved in both January and February. **We expect growth in Chinese construction investment to increase to around 20% y/y at the end of 2016**, before levelling off again, to a 10-15% rate in 2017. This should support a moderate rise in industrial growth as well, as many industries are suppliers to the construction sector.

Why the recovery could be significant for China

Apart from lifting Chinese growth, the improvement in construction could prove important in many respects.

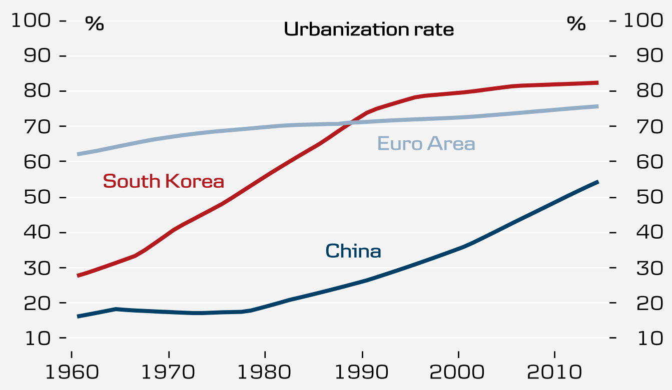
- **Overcapacity:** Chinese industries with overcapacity centre on the sectors with high exposure to construction. This goes especially for steel, cement and aluminium. Overcapacity in the developer sector is also benefiting from the rise in home sales and decline in empty houses.

Chart 9. Easing of Hukou rules to keep up already high urbanisation



Source: Macrobond Financial, World Bank

Chart 10. Urbanisation is part of the catching up process – more to come in next two decades



Source: EMadvisors, Danske Bank

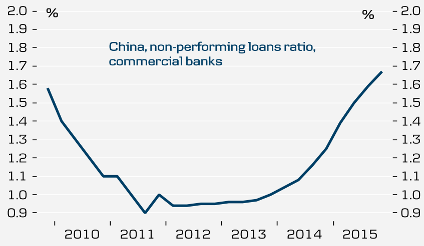
- **Banks and non-performing loans:** Chinese banks have a lot of exposure to construction and the rise in non-performing loans is to a wide extent due to problems in the above-mentioned industries with overcapacity. Therefore, higher growth in these sectors would ease some of the problems with non-performing loans. While the issue will not go away, it becomes easier for the government to handle if the pace of deterioration calms down. It is likely the government will need to recapitalise banks but the issue will be manageable if China is able to stop the hard landing in construction.

- **Chinese deflation:** Worries about deflation will reduce quickly if a construction recovery drives a lift in raw material commodity prices. As Chart 12 shows, the deflation in Chinese producer prices is very much a case of falling commodity prices. If raw materials prices recover further, producer price deflation would end rapidly.

- **Chinese stock markets:** The fears over a hard landing of the Chinese economy as a whole have been extensive over the past six months. This is seen most clearly in the offshore stock market The Hong Kong China Enterprise Index (onshore stocks have also taken big hit but this is not related to the economic development). Chart 13 tells the story: the stock market has been hit hard and much more than the development in activity has warranted. Fears over a banking crisis (the offshore stock index has a share of 65% of financials stocks) have run rampant. If the fear of an overall hard landing eases, we believe this should provide a lift to Chinese offshore stocks.

Hence, a wide range of problems and issues that are currently causing concern would gradually improve if the Chinese construction sector is about to recover as we expect.

Chart 11. Official non-performing loans ratio of Chinese banks



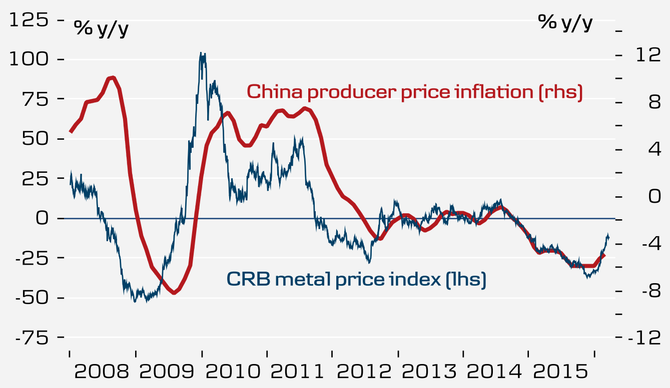
Source: Macrobond Financial

Why it matters for global markets

The spill over to the rest of the world from the hard landing in construction has been significant and should benefit from higher activity.

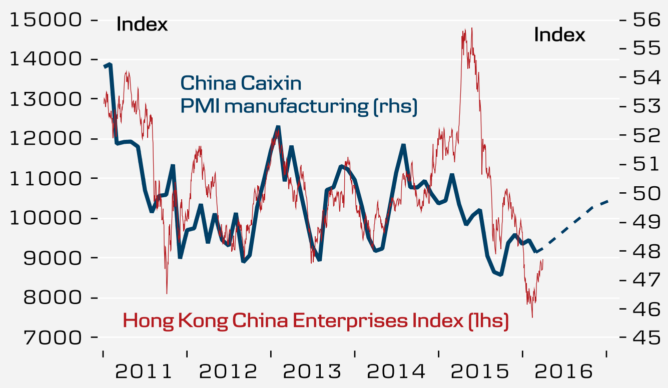
Global risk sentiment: Global fears of a hard landing in the Chinese economy have been extensive over the past six months and in combination with turmoil in both the Chinese exchange and equity markets, it took a strong toll on global risk sentiment. The fears of a hard landing have already eased and we expect this to continue as the year moves on and the recovery of the construction sector unfolds. Hence, we expect the drag on global risk sentiment from the China factor to fade further in 2016.

Chart 12. Deflationary pressure in China is all about commodity prices



Source: Macrobond Financial, Danske Bank

Chart 13. A moderate recovery to underpin Chinese stocks

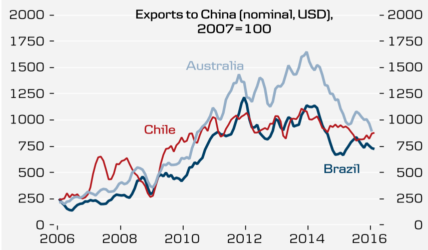


Source: Macrobond Financial, Bloomberg, Danske Bank

- **Global commodity markets – especially base metals:** As shown above, China consumes close to 50% of many base metals and much of this is used in construction. As Chart 1 on the front page shows, a gradual lift to Chinese construction would underpin global raw materials prices. The increase in base metals this year may also be an early sign of a bottom in Chinese activity.
- **Commodity exporters:** The rapid decline in demand for commodities over the past few years, as well as a fall in prices, has been a big hit to commodity exporters of base metals and many of these are to be found in emerging markets. Not least, Brazil is a big exporter of base metals with iron ore having the largest share of Brazilian exports. However, other Latin American countries such as Chile, which is a major copper exporter, would also benefit. Many African countries are also net exporters of minerals, with South Africa being the biggest net exporter of metals such as platinum (80% of the world's platinum is in South Africa) and iron ore. China is the number one export destination for South Africa. Another beneficiary would be Australia, which is the second largest producer of iron ore in the world (after China).

To conclude, a recovery in the Chinese construction sector could prove a game changer. The hard landing in this sector has had consequences not only for Chinese growth but also for global risk sentiment, base metals commodities and emerging markets commodity exporters.

Chart 14. Exporters of iron ore and other metals hit by China slowdown



Source: Macrobond Financial, Danske Bank

Disclosures

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