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Interesting opportunities for Asian property stocks

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Global GDP growth is slowing, largely due to significantly higher interest rates around the world (see Figure 1 below). Higher interest rates are the result of deliberate policy action by central banks globally to combat higher inflation, which in turn is predominantly the result of tight labour markets, on the one hand, leading to higher wage growth and "sticky" inflation, and higher energy and commodity costs as a result of the Russia-Ukraine conflict on the other. During the COVID pandemic, governments could swoop in to help consumers, but high inflation prevents it this time around, as any fiscal efforts would stoke inflation further. We are likely stuck with slowing growth globally until inflation has reduced significantly, which itself would likely be the result of weaker economic growth.

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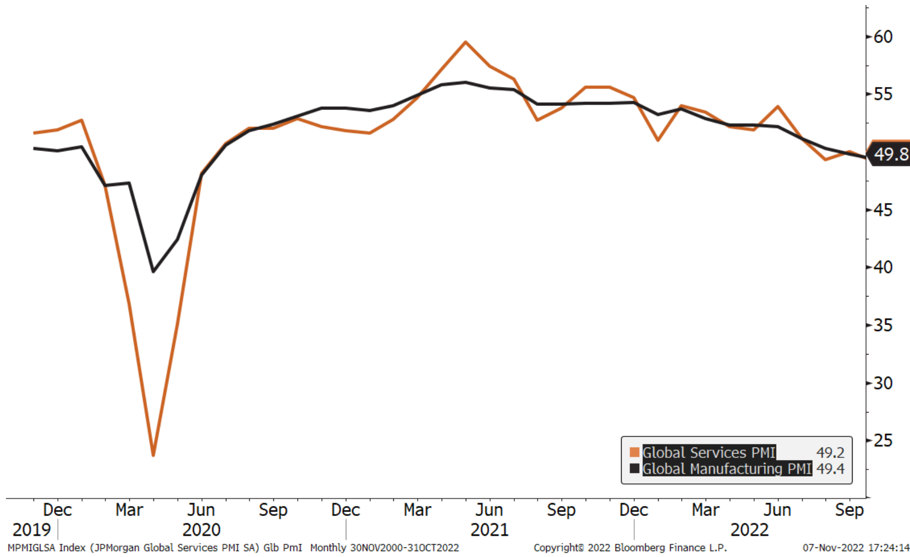
Global growth is slowing

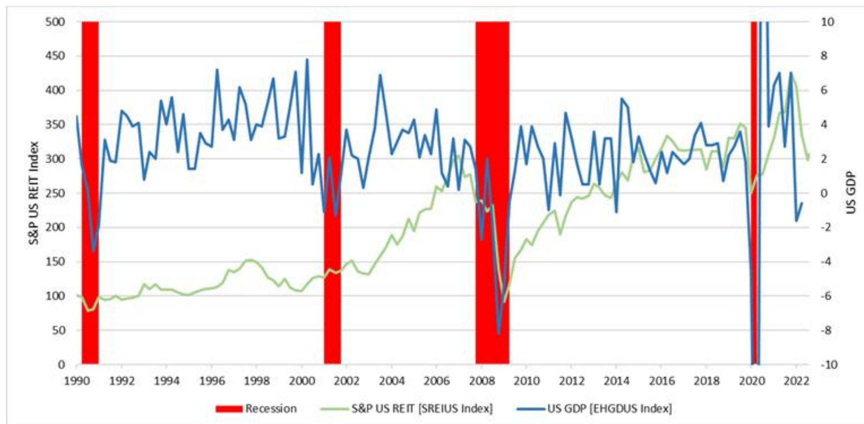
Figure 1: JP Morgan Global Services & Manufacturing PMI



Source: Bloomberg

The slowdown of global growth is bad news for property stocks because there is a strong correlation between property stocks and the underlying economy (see Figure 2 below).

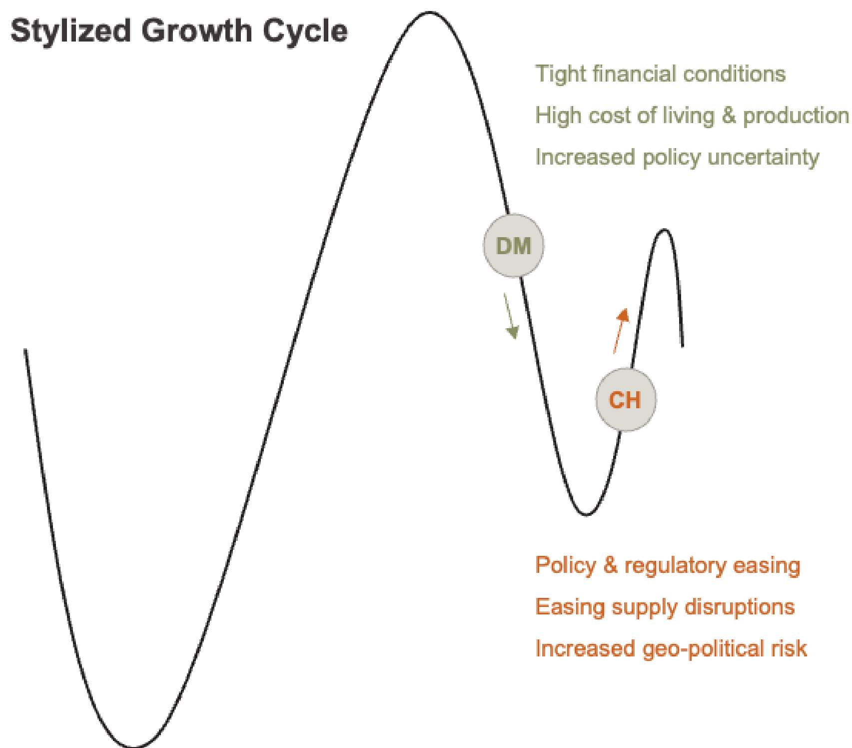
Figure 2: Property stocks and economic growth (US S&P REIT Index and US GDP)



Source: Bloomberg and National Bureau of Economic Research (NBER)

However, growth is not slowing down equally around the world, leading to some interesting opportunities (see Figures 3 and Table 1 below). Looking at where the major global economies are in their growth cycles, most developed markets are still slowing, whereas China has already rebounded from 0.4% real GDP growth in the second quarter of 2022 to 3.4% in the third quarter. Furthermore, China's inflation is contained at less than 3% (unlike the US and Europe at 8% and 10%, respectively) allowing it the latitude to stimulate the economy if it so desires, which seems likely given below-trend economic growth currently. The most obvious policy action would be to ease up on the zero-COVID policy, but the Chinese government could take numerous other monetary or fiscal steps.

Figure 3: Growth in developed markets falling and China rising



Source: Bloomberg. As at 6 Sep 2022

Table 1: US, EU and China GDP Growth, 2021-2023E

	2021	2022 CONSENSUS	2023 CONSENSUS	FAIRTREE VS CONSENSUS
US	5.9%	1.7%	0.5%	↓
EU	5.2%	3.0%	0.0%	↓
China	8.1%	3.3%	5.0%	↑
SA	5.5%	1.8%	1.4%	→
World	6.0%	2.9%	2.3%	→

Source: Fairtree

Many South African clients want exposure to developed markets because they live in an emerging market and therefore have plenty of exposure to them already. As a result, exposure to China is less desirable, and to be fair, there are plenty of complexities involved in investing in Chinese property stocks right now that would make that less attractive anyway. Over the next year or two, it is not clear that the Chinese government wants to save the private property sector, which is suffering due to a cash flow crunch brought on by its overexpansion and the government's tighter lending requirements. From a longer-term perspective, China's property outlook is also not that bright because of a declining population and already high urbanisation levels, leading to structurally lower demand.

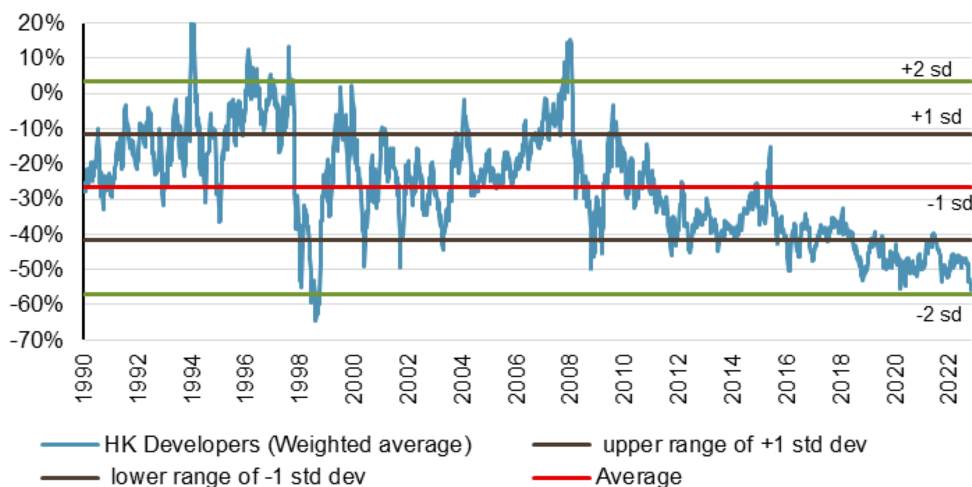
Enter Hong Kong. This developed market is in an unusual situation in that it derives the bulk of its economic growth from China, while it gets its interest rates from the US because of its pegged currency. This means that its monetary policy is not tailored to its economic growth requirements, making it one of the most volatile property markets globally. As a recent example, China's GDP growth was weak, and therefore Hong Kong's GDP growth was weak too. At the same time, however, the US economy was overheating, which led to raising interest rates – which in turn led to higher Hong Kong interest rates, the opposite of what was needed. Unsurprisingly, Hong Kong property prices weakened.

Stock markets are discounting mechanisms, and therefore we need to invest based on "where the puck is going, not where it is", to paraphrase the famous ice hockey player Wayne Gretzky. In six to 12 months, we expect US interest rates to have peaked and China's GDP growth to have accelerated further.

This positive demand outlook is enhanced by a limited housing supply in Hong Kong due to a lack of available land. The favourable fundamental outlook combined with attractive stock valuations should result in a share price upside.

According to UBS data, the development property stocks are trading at a 56% discount to NAV, two standard deviations (SD) below the historical trading average, largely in line with the COVID trough. They are trading at a 6.8% forward dividend yield, over three SD above the historical average and even slightly higher than the trough level in 2003 during the SARS outbreak. In terms of spread (dividend yield – US 10-year treasury), the sector is trading at 2.6%, one SD above the historical average and in line with the Global Financial Crisis and Asian Financial Crisis highs. Investors have seldom lost money investing at these levels.

Figure 5: Hong Kong Development Property Stocks Discount to NAV, 1990-Current

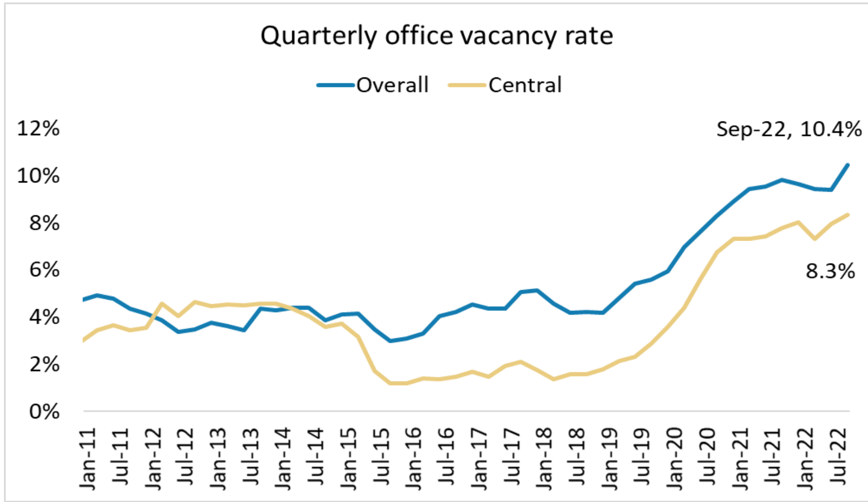


Source: Datastream, UBS estimates

Why Hong Kong developers and not Hong Kong office property stocks – both demand and supply?

'Work from home' has eroded global office demand substantially, to such an extent that it will likely take years to organically refill the excess space created by employees who choose to spend less time in the office. In the US, for instance, many cities around the country have less than 50% real occupancy (meaning bums on seats), as opposed to the leases signed. The slowing economy will exacerbate the already fragile state of office markets globally. Office vacancy levels in Hong Kong are already high at over 10%, and we expect them to rise further (see Figure 6 below).

Figure 6: Hong Kong office vacancy high and rising



Source: Morgan Stanley Research

In conclusion, global property stocks are in for a rough time in the near term due to the combination of slower economic growth and higher interest rates. The former hits demand while the latter raises cap rates which hits the asset values. An exception is China, where growth is accelerating already, which should also translate to higher growth in Hong Kong. With higher interest rates already baked into the cake in Hong Kong, combined with attractive stock valuations, we believe the six- to12-month outlook for Hong Kong property stocks is attractive.

Glacier Research would like to thank Rob Hart for his contribution to this week's *Funds on Friday*

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Rob Hart graduated with a B.Bus.Sci (Fin) from UCT in 1995, then headed to Hong Kong to join Morgan Stanley Equity Research, where he stayed for 12 years, leaving as managing director and heading up the Hong Kong Strategy, Regional Property, Regional Conglomerate, and Regional Gaming teams in 2008. He then moved to Singapore to join Sansar Capital as a portfolio manager focusing on property and property-related stocks, and in 2013, he moved to Ivaldi Capital to run a similar mandate.

Following 20 years overseas, in 2016, Rob decided to head back home to South Africa and joined Fairtree to launch the Fairtree Global Real Estate Prescient Fund.

Having completed the Seven Summits in 2012, Rob now enjoys less risky pursuits, including cycling, trail running and climbing the occasional mountain with his sons.