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Q&A-China property crisis 'misunderstood' by many; financial crisis unlikely: Michael Fritzell, author, *Asian Century Stocks*

China's property market crisis is misunderstood by most investors, **Michael Fritzell, analyst and author of Asian Century stocks**, told the Reuters Global Markets Forum on Tuesday, September 5.

"After the Three Red Lines policy in late 2020, private property developers -- the most leveraged ones -- have been basically cut off from credit and now defaulting on their obligations to offshore bond holders, that's why new starts are down this much," said Fritzell.

"Cutting them off from credit solved the over-construction problem, and that could be positive for productivity in the short run," he said.

"I don't foresee a negative feedback loop with falling property prices causing a financial crisis like the one we saw in the U.S. in 2008. We're rather seeing a soft nationalisation of the residential property market."

Chinese outbound travel may never recover completely, added Fritzell, but as travel resumes globally, tourism sectors in Southeast Asia should benefit.

Following are edited excerpts from the conversation:

Q: What's your outlook on Asian markets broadly? Given the global monetary policy tightening cycles, are there certain regions you are specifically more constructive/positive on than others?

A: Well, I think Asia is a diverse market that's hard to generalise across. You have export-focused markets in East Asia, dependent on global goods demand. And Southeast Asian markets that are more dependent on commodity prices and portfolio flows. India is almost a continent of its own, that I personally spend little time on. With current high interest rates in most markets ex-China, I think it's appropriate to be defensive. I do think some Southeast Asian markets such as Malaysia, Singapore and the Philippines offer value. Consumer stocks in China also offer decent value, but I'd be careful with anything construction-related.

Q: Are there any good buying opportunities in China? What are some equity themes that are likely to arise out of this going into the next year?

A: Yes, I think the Chinese consumer story is excellent. Household balance sheet built up during the zero-COVID policy. Restrictions have almost been completely removed. Restaurants can operate at full capacity again, both in Hong Kong and China. Companies like Cafe de Coral and Fairwood are reporting strong rebounds in revenues. The transport sector also offers decent opportunities. While outbound travel may not recovery completely -- that depends on government policy -- domestic travel is as strong as ever, and many transport stocks remain cheap. I don't foresee debt deflation occurring in China. I think what happened in the property market is misunderstood by most investors. After the Three Red Lines policy in late 2020, private property developers -- the most leveraged ones -- have been basically cut off from credit and now defaulting on their obligations to offshore bond holders. That's why new starts are down this much. Frankly, cutting them off from credit solved the over-construction problem. And that could be positive for productivity in the short run. I don't foresee a negative feedback loop with falling property prices causing a financial crisis like the one we saw in the U.S. in 2008. We're rather seeing a soft nationalisation of the residential property market.

Q: Is the optimism in markets sparked by China's latest easing measures likely to last? Or will we likely need to see more meaningful stimulus measures being announced?

A: With regards to stimulus, Chinese credit growth has been disappointing and from what I hear, Xi (China President Xi Jinping) is unwilling to provide households with cash handouts or any other consumer-related stimulus measures. So it looks like credit growth will remain tepid. Though I'll just continue monitoring the monthly data, which does not look bullish yet.

Q: What asset classes/pockets of attractiveness you're seeing in Southeast Asian markets such as Malaysia, Singapore and the Philippines?

A: When it comes to Southeast Asian markets, my favourite market for the time being is the Philippines. Foreign investors have basically left the market after its peak in popularity in 2013. BBM is encouraging private sector investment, including participation in infrastructure PPP projects. I can well see, once Bangko Sentral reduces interest rates, that we'll see greater capital formation and the start of another credit cycle there. And most stocks remain very inexpensive, certainly in relation to the market's high return on equity. One theme that I continue to like is Southeast Asian tourism. Chinese outbound travel may never recover completely, but in the rest of the world people are travelling freely again. Companies like Multi Bintang that sell a large portion of their products to tourists should benefit.

Q: How about the oft-repeated "deglobalisation" narrative/theme -- does that hold water, and is that going to continue to be an important theme/growth driver for Asian markets?

A: Yes, I think that's a real trend. Japan, Korea, Taiwan, China and now Vietnam built up their middle class by manufactured goods exports. Today, MNCs in China are not reinvesting new capital but just reinvesting profits from their existing operations. New FDI will find its way to Vietnam, and to a lesser extent Thailand Malaysia. That means that China's middle class will suffer, and those of Southeast Asia benefit. That has implications for the demand of a variety of products exhibiting S-curve characteristics, including autos, commodity housing, appliances, etc.

Q: How are you assessing Japan's appeal, particularly for foreign investors?

A: I'm near term bullish on Japanese equities, because it's an export market and the yen is exceptionally weak. That bodes well for earnings growth. Also, Japanese corporates have become more shareholder friendly with TSE's guidelines causing companies to put a greater focus on return on capital. Japan's dividend yield is now greater than in the rest of the world, and the currency is attractive, too. One caveat though, is that if the rest of the world enters into a recession perhaps by mid-2024, Japanese exporters would suffer as well. So I don't have much conviction on the index. I also imagine there has been significant carry trade outflows, that will eventually return once the USD-JPY interest rate differential eventually narrows.

Q: Is that your base case, a recession by mid-2024?

A: Yes, I think U.S. interest rates are prohibitively high. With a 7.2% 30-year mortgage rate, affordability is now weak and I can't imagine that the construction will continue at this pace forever. We're already seeing U.S. non-farm payrolls falling gradually to zero by March 2024, and according to macro analyst like Warren Pies, a recession typically follows by 2-3 months. High U.S. interest rates have implications for housing markets in Singapore, Hong Kong, Korea and Australia. I see value in developed long-term government bonds for that reason.

Q: Any parting thoughts for us?

A: I think we've touched on the broad themes. I'm personally bullish on Chinese consumer and transport stocks in a post-COVID environment, they remain exceptionally cheap with improving fundamentals. I also like Chinese SOEs (state-owned enterprises), which have come down to reasonable valuations due to U.S. sanctions. Examples of such stocks include CNOOC (China National Offshore Oil Corporation) and the telcos. Finally, I believe that there are opportunities in Malaysia, where foreign ownership is now the lowest since 2004. And there are many hidden gems for those willing to dig deeper.