Connecting the dots

How China's economic malaise could affect U.S. real estate markets

by Will McIntosh, John Kirk and Mark Fitzgerald

Do you remember when China consistently delivered quarterly GDP growth above 7 percent, had one of the fastest-growing stock markets in the world and minted 1 million new millionaires in only 12 months? It is hard to believe that was only a year ago, particularly because China recently has become what many investors fear most from an economic superpower — unpredictable. In the past few months, the country's image of stability has fractured because of a combination of financial missteps and economic underperformance. Meanwhile, U.S. real estate investors have been watching things unfold safely outside the impact zone of this economic malaise, treating it primarily as a peripheral issue. In all likelihood, that is the right approach — but what if it's not?

What happened in China?

In recent months, a series of major economic events occurred in China, starting with a stock market sell-off that sparked investor concern around the globe. After climbing nearly 150 percent over the past year, the Chinese stock market peaked in June before falling 30 percent in only a few weeks. Fearing further decline, the Chinese government intervened with an extraordinary initiative to purchase nearly every share as investors retreated from the market.

History will judge whether this unprecedented measure was successful. The government has spent nearly $1 trillion so far, according to a recent Reuters story, and the stock market was still down more than 30 percent two months after the intervention. No one knows if the market would have fallen further without government intervention; however, this situation caused the global investment community to question the near-term growth prospects, as well as the financial decision making, of the second-largest economy in the world.

Following the stock market slide, the consensus was China's GDP would underperform, at least slightly, because equities often are leading indicators of economic performance, but that was not the case. Instead, officials announced in July China had achieved its 7 percent GDP goal. Many market participants were skeptical of this claim, and recent economic indicators confirm those suspicions.

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Barely a month after the surprise GDP number, the People's Bank of China slashed short-term interest rates to help boost growth, manufacturing data fell to its lowest point since the global financial crisis, and 11 shadow banks formally requested a multibillion-dollar bailout from the government to backstop loans from borrowers. Because of China's lack of transparency, it is difficult for outsiders to calculate an accurate forecast, but most economists believe GDP growth is between 2 percent and 5 percent, significantly lower than the 7 percent previously reported. The current situation makes it challenging to gauge the actual effect on the global economy, and it damages China's credibility relating to economic disclosure.

Although the previously described incidents may have raised investor concerns, China's next move could prove to have the biggest impact on the global economy. On Aug. 10, officials allowed the yuan to devalue against the U.S. dollar. On the first day, it fell 1.9 percent. By the end of the week, the yuan was down 3.1 percent against the dollar, totaling the largest weekly movement in a decade. This caused a domino effect as countries that count China as a significant trade partner scrambled to adjust their currency and economic strategies; this was especially troubling for many emerging and developing countries.

Generally, the market viewed this decision as China's attempt to boost domestic growth and improve its trade balance, yet some people saw it as the first strike in a currency war. We do not believe a currency battle was China's primary intention. In fairness, the yuan was pegged to the dollar during the previous five years and appreciated 25 percent during that time. Therefore, even though the currency fell substantially, it was not as significant when compared with recent appreciation.

Concerns remain, however, that China might try to regain market share lost to countries such as India, South Korea and Germany, all of which expanded imports to the United States at a faster rate over the past five years. China is still the leading exporter to the United States in terms of total dollar value, but "any attempt to gain truly meaningful competitiveness vis-à-vis trading partners would require, say, a 20 percent to 40 percent devaluation against the dollar," according to Jonathan Anderson, an emerging markets economist at Emerging Advisors Group, in *Fortune*. Such a significant move could disrupt the global trade equilibrium and capital markets, particularly if the change occurs suddenly, as was the case with the initial currency devaluation.

How does this affect U.S. real estate?

China's economic downturn could influence U.S. real estate in several ways, including how the Federal Reserve Board approaches interest rate movements, the supply/demand equilibrium concerning oil prices, and the impact on China's trade partners that also invest in U.S. capital markets. Yet we believe the potential for the most disruption lies in China's capital flows into U.S. real estate markets, and our belief is based on China's stock market collapse and recent currency devaluation.

On the surface, China's stock market decline may seem irrelevant to U.S. real estate investors; however, the equity market expansion was not a random occurrence. Instead, the government created this situation with the intent to boost the economy and generate wealth. After China had one of the world's worst stock market performances in the previous three years, according to *The Economist*, China's central bank cut interest rates in 2014 for the first time in two years, adopted a loose monetary policy, and injected at least a trillion yuan ($163 billion) into the economy. Consequently, China's stock market ran up 150 percent and, at its peak in June 2015, became the world's second-biggest equity market, with a value of $4.5 trillion.

In the 12 months leading up to the equity-market peak, cross-border capital into U.S. commercial real estate surged. Chinese investors transacted $6 billion during this period, double the amount from the previous year, according to Real Capital Analytics. This increase was not a coincidence. In fact, we believe many Chinese investors gained substantial wealth during the equity market bubble and reallocated a large amount to U.S. real estate prior to the downturn. Now that the stock market has slowed, a flight to quality is likely as Chinese investors pursue strong investments such as U.S. real estate.

Over the long term, however, we expect less cross-border capital from China. Even though Chinese investors seem to have plenty of capital reserves to deploy, there should be at least a modest impact on the overall volume of investable cash flow to U.S. real estate, given the stock market, which was the country's primary growth engine, lost more than $1.3 trillion as of mid-August (almost one-third of its total value).

No one has a crystal ball but, in light of recent events, it might be time to consider some unlikely outcomes.

The effect of China's slowing stock market is not enough by itself to curb capital flows, but it could be significant when combined with a volatile yuan devaluation. As previously mentioned, the yuan fell 3.1 percent against the U.S. dollar over the course of one week and, as a result, U.S. real estate became that much more expensive to Chinese investors. In a market where deals sometimes are determined by a few basis points, a spread of several hundred basis points may seem like an unsurmountable hurdle. For Chinese investors, however, a 3 percent premium — or even 8 percent, as suggested by a recent CBRE study — is unlikely to deter them from diversifying their portfolios to the safety, security and economic-growth opportunities associated with U.S. real estate. It would be nearly impossible, however, to overcome a yuan depreciation of 20 percent or more, which could occur if China makes a meaningful attempt to regain market share from other U.S. trade partners as previously described.

Will this volatility create opportunity?

We are not expecting a complete shutdown of the capital flows from China to U.S. real estate markets. In fact, investment capital from China already totaled $4.8 billion through the first half of the year, according to Real Capital Analytics. Certainly, the United States will continue to attract an abundance of capital due to a robust economy and the general lack of high-quality investment yield available in today's global markets. But China's falling stock market, combined with the potential for a volatile yuan depreciation, could have a meaningful impact on the country's capital outflows over the long term. Such a decline in foreign capital would create an opportunity for investors, particularly those that have been priced out of gateway cities.

To put this in perspective, China's cross-border investments into U.S. real estate totaled $3.5 billion in 2014, roughly 1 percent of total direct transactions, according to Real Capital Analytics. This may sound like a small number, but the effect is substantial for some gateway markets. In fact, Manhattan, Los Angeles, Chicago and San Francisco accounted for almost 70 percent of all direct investments from China in 2014. It is worth mentioning that Real Capital Analytics only accounts for direct real estate transactions from Chinese investors, and the overall volume of cross-border capital is substantially larger when considering the vast amount of private transactions of foreign capital through domestic U.S. funds and similar investment vehicles. Therefore, any material slowdown in foreign capital flows will have a direct impact on several major markets, with downstream implications for other cities as well.

What are the odds?

Given that China has never been the catalyst of a global recession, the most probable scenario is the country's economic woes will have limited effect on U.S. real estate markets. Yet six months ago, the odds were near zero the Chinese government would initiate an unprecedented stock market intervention following a massive sell-off, then announce the country had nailed its 7 percent GDP goal despite clear signs of economic turmoil and, shortly thereafter, allow the largest one-week currency devaluation against the U.S. dollar in more than 10 years. Certainly, no one has a crystal ball but, in light of recent events, it might be time to consider some unlikely outcomes. ❖

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