SBI RESEARCH
ECOWRAP

FRONTLOADING FED RATE HIKES & CHINA'S WORSENING CONSTRUCTION BUBBLE: IS INDIA ENJOYING THE NEW 'TINA' MOMENT IN A CHECKMATE WORLD EMBRACING PLUS ONE?

Issue No. 29, FY23
Date: 30 August 2022

Fed chair Jerome Jay Powell's shorter, narrowly focussed yet decisively direct 9 minute address last Friday from Jackson hole, Wyoming symposium right before the onset of fall, preceding deep snowfall thereafter, jolted the markets out of exuberant inertia, settling in motion of late on probability of frontloaded pace of future hikes. Specifically, Fed Chair Powell statement that "*which is that we must keep at it until the job is done. History shows that the employment costs of bringing down inflation are likely to increase with delay, as high inflation becomes more entrenched in wage and price setting. The successful Volcker disinflation in the early 1980s followed multiple failed attempts to lower inflation over the previous 15 years*". **Clearly this statement is a serious reaffirmation of the Fed's commitment to frontload rate hikes by central banks, a policy that RBI has most successfully deployed!**

Broader markets, naturally did not love the statement much; US stocks gave in the monthly gains in a single day, yields on benchmark securities spiked while the Dollar firmly moved to its twenty year highs, threatening the peer currencies and economics of trade. **Fed funds futures now show odds of 75 bps rate hike in September meet at ~70%, while Euro zone money markets are now pricing ~67% chance of a 75 bps ECB rate hike in September, up from 48% right before Powell speech.**

Central Banks are now clearly walking to the days of hard landing ahead, aligning more with data dependant decisions, a corollary perhaps to their missing the boat on inflationary prints in hindsight, and the RBI may not want to be an outlier in forthcoming September policy, more so as Fed policy is lined up on Sep 20-21, ahead of RBI announcements.

However, the important thing is that equity and currency markets in India though having reacted adversely, were quick to recoup some of the loses in subsequent trades, with portfolio inflows turning positive even though marginal at $30 million on Aug 29th. The overall portfolio inflows since July29 is now $7.6 bn, as against an outflow of $14.7 bn in FY23 prior to July29th. **Clearly, India seems to be enjoying the TINA (There Is No Alternative) factor, as globally all countries are facing the churn and India seems to the best placed jurisdiction in terms of growth and inflation outlook in FY23. We share such optimism as China is also facing a bleak outlook on the back of a construction sector meltdown.**

In fact, we believe the China story may now be facing clear headwinds and India is likely to benefit from such stark realities over the longer term. The trends in prices of both retail and commercial real estate in China now show much deeper structural adjustment. The long-term trends in retail prices show that since 2016, prices have been steadily declining along the linear trend. In 2022, even the nominal price index has witnessed degrowth which is a worrying sign. The real price index growth has been in negative growth since December 2021. Home sales in China have fallen for 11 months in a row, official data shows. That is the longest slump since China created a private property market in the late 1990s.

Chinese demographers are now predicting that negative population growth in China will be the dominant trend in the coming years for a long time and improving the overall quality of the population and changing economic development plans are vital to address the problem. **With ageing, size of the family will gradually shrink. The housing demand will eventually decline in the long run in China as seen in Japan.** The future outlook of the construction sector in China over the long run structural factors such as demographic ageing and rebalancing of economy will eventually remove a substantial portion of demand.

India is likely to be the beneficiary as China slows down in terms of new investment intentions. Global tech major Apple's recent decision to shift part production of its flagship iPhone 14 model for worldwide shipping from India, with a negligible time lag of a few weeks post its slated launch on September 7, bears testimony to such an optimism! The move by Apple, the most recognisable face of tech infused innovation in the last two centuries, that captures aspirations of an upwardly mobile population should open the flood gates for other major conglomerates to follow suit. Interestingly, even as China is grappling with a meltdown in construction sector, housing unit sales in India in H1 2022 (Jan-June) have reached the highest level since H12013. Low interest rates and comparatively low home prices along with the renewed need for home ownership sparked by the pandemic, have been the primary drivers for this growth. Growing by 60% in YoY terms, the sale of 158,705 units during H1 2022, was 19% higher than the preceding period of H2 2021 in seven major cities.

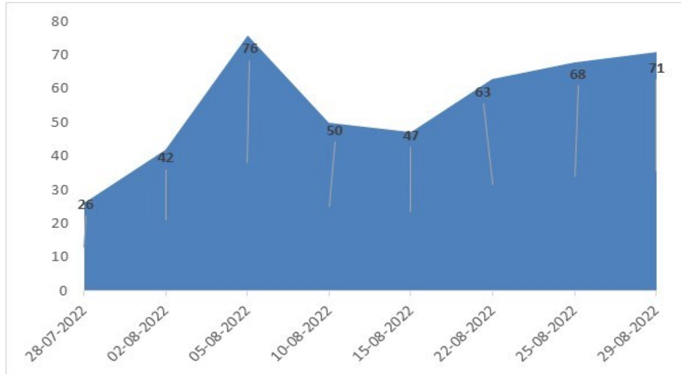
LOOKING THROUGH THE JACKSON HOLE HULLABALOO

- The carefully deconstrued minutes of much anticipated Jackson Hole address by Fed chair Jerome Powell last weekend reaffirmed the likelihood of Fed (and other Central Banks in all probability) sticking with their uber hawkish stance in combating inflationary prints going forward till the vision towards stable 'price stability' appears clearly in 'rear view'. **The 9 minute direct, shorter and narrowly focused address by Fed Governor mentioned price stability nine times,** reigniting impassioned/animated debates, and knee jerk reactions by markets on future pace and quantum of rate hike trajectory, while also fully watering down the jubilant sentiments that had emerged on horizon since July about a tapered approach on future hikes. Using tools available to Fed '**forcefully**' to bring demand and supply into better balance while accepting sustained period of below-trend growth to restore price stability within mandated levels, the troika of higher interest rates, slower growth, and softer labour market conditions in days ahead would bring pains for households and businesses, Powell said in no beguiled way. The longer term neutral-rates are not a milestone any longer in these fluid like situations, but more of a evolving and shifting edifice of economy as echoes of 75 bps rise in next Fed meet gains currency by a wider market set, reminiscent somewhat in a diluted way, of the 80s when Volcker sledge hammered the inflation through counter cyclical attacks.

CHINA+1: THE NEW LOOKING EAST POLICY

- As the largest democracy of the world seems set to overtake mainland China in terms of population, there are also talks growing about the emergence of a new world order where the global chaebols are reinforcing, in a re-calibrated supply chain management effort, the **China+1 model, shifting part of their manufacturing to competitive locations in the vicinity** which offer skilled labour set and other enablers at a comparatively sweetened price while having a simplified 'ease of doing business' ecosystem, incentivising competitiveness and innovations both seamlessly.
- While there are many suitors for the immense opportunities that these 'stable' investments from global majors promise in the intended geography, from Taiwan to Vietnam to Philippines to neighboring Bangladesh, we understand the inherent sweet spots of Indian economy make out a stronger case for majority tilting in favor of the largest democracy of ours.

Fed Funds Futures showing odds of 75 bps hike



Source: SBI Research

- Global tech major Apple's recent decision to shift part production of its flagship iPhone 14 model for worldwide shipping from India, with a negligible time lag of a few weeks post launch on September 7, mirrors the double edged strategy of many a heavyweight brands who wish to penetrate one of the largest and lucrative markets, riding high on affluence chasing, experiment centric consumers whose psyche and spending patterns both are undergoing tectonic shifts as omnipresent India stack and right doses of policy measures are creating a pro-business environment, that in essence, is pro-people at a grander scale.

- The Foxconn facility at Chennai should meet the demand at both international shipments, as also domestic levels through an exclusively earmarked DTA (Domestic Tariff Area). The move by Apple, the most recognisable face of tech infused innovation in the last two centuries, that captures aspirations of an upwardly mobile population should open the flood gates for other major conglomerates to follow suit as right policy injections viz. PLI level the playing field in a checkmate world. Seems, India is slated for a 'TINA' movement on investment front!

THE SITUATION IN CHINA

- Since the default by Evergrande group, once hailed as the toast of Chinese infrastructure resurgence, the financial situation of construction sector in China has steadily moved southwards. The debt default by Evergrande group spread to other large and mid-tier construction companies. Listed developers' share prices have fallen US$55 billion during 2022, while the sector's dollar notes have fallen by more than US$35 billion. Bank loans to the real estate sector have dropped for the first time in 10 years.

- With mouthing delays, there were mass boycott of mortgage payments or willful default as overleveraged developers that sold homes and haven't finished on commitments. This has exposed the lower tier banking in China to serious risk of contagion which required urgent policy action.
- The situation has been compounded by strict zero-covid policy that has disturbed the normal flow of activity in construction sector which is almost entirely labour dependent. The near-term outlook of the construction sector to remain challenging because of the uncertainties relating to the Evergrande debt problems and downgrades by international credit rating agencies.

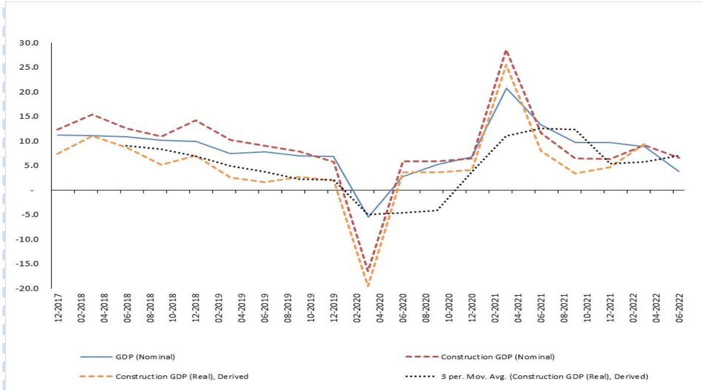
TRENDS IN CONSTRUCTION GDP

- Construction sector has been the primary engine of China's growth over years. Accounting for over 20% share in GDP sector has propelled growth of China from rural country to an urban. The recent trends in overall GDP and construction GDP are shown in graph.
- The construction sector has been on a steady slide since 2016 which prompted the rebalancing strategy of moving to high-end value-added manufacturing and services. Since the outbreak of COVID-19 in 2020 the sector suffered a sharp contraction has recovered by 2021 but is again sliding due to strict zero-COVID policy.
- As a result, China's GDP has slowed in Q2 to 3.9%. Given the current trends, the sliding trend will not correct, and it will take some time till issue in construction are resolved. China is poised to miss its growth target of around 5.5% this year and youth unemployment is at a record 20%.

TRENDS IN CONSTRUCTION PRICES IN CHINA

- The trends in prices of both retail and commercial real estate show much deeper structural adjustment. The long-term trends in retail prices show that since 2016, prices have been steady declining along the linear trend. In 2022 even the nominal price index has witnessed degrowth which is worrying sign. The real price index growth has been in negative growth since December 2021.
- The segregation of price trend in into retail and commercial for Beijing areas show a similar trend as above with local dynamics at play. The price recovery in both retail and commercial space has been modest since the outbreak of the COVID-19. While commercial prices are declining commercial prices are plateauing.

China's Overall GDP Vs. Construction GDP

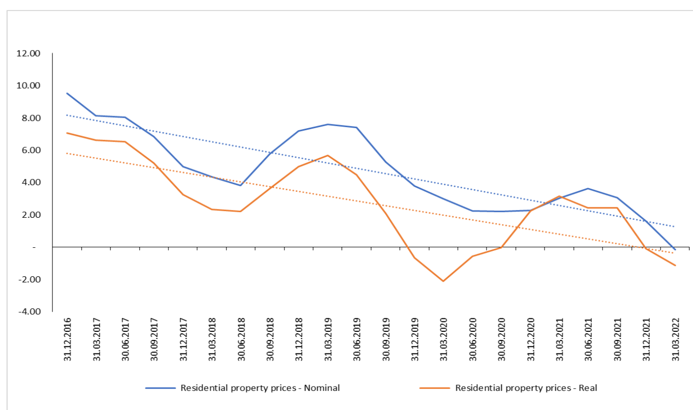


Source: SBI Research

Property Price in Beijing, China (YoY%, Index 2010 =100)

Source: BIS Detailed Residential Property Price Statistics, July 22, SBI Research

Residential Property Price in China (YoY%, Index 2010 =100)



Source: BIS Selected property, July 2022 price series, SBI Research

- While the commercial space still has the opportunity to growth organically given the strides made by China in new economy. The ongoing relocation of foreign firms under China+1 and possible conflicts in the region, the long-term gains are capped.
- Home sales in China have fallen for 11 months in a row, official data shows. That is the longest slump since China created a private property market in the late 1990s.
- Chinese demographers has predicted that negative population growth will be the dominant trend in the coming years for a long time and improving the overall quality of the population and changing economic development plans are vital to address the problem. With ageing, size of the family will gradually shrink. The housing demand will eventually decrease in the long run as seen in Japan.

MONETARY POLICY RESPONSE

- PBOC cut its benchmark lending rate and lowered the mortgage reference by a bigger margin to revive an economy hobbled by a property crisis and a resurgence of COVID-19 cases. The one-year loan prime rate (LPR) was lowered by 5 basis points (bps) to 3.65% at the central bank's monthly fixing on Monday, while the five-year LPR was slashed by 15 bps to 4.30%.
- China will offer 200 billion yuan ($29.3 billion) in special loans to ensure stalled housing projects are delivered to buyers, ramping up financing support for property sector.

FUTURE CHINESE OUTLOOK

- The future outlook of the construction sector for next one year is only marginally positive given the scale of measures taken. However, over the long run structural factors such as demographic ageing and rebalancing of economy will eventually remove a substantial portion of demand.
- The impact of the current trends in the short term is that steel prices will eventually correct as Chinese appetite will be limited.
- The global GDP outlook will only tilt towards negative if the current property crisis prolongs in future.

Impact on Retail & MSME Consumers due to Rise in External Benchmark Rates (Rs crore)	
Type of Loans	Increase in Interest Cost on Rs 1 Lakh/year loan due to Rise in Repo Rate by 140 BPS
Personal Loans	893
Housing (Including PS Housing)	981
Education	617
Vehicle Loans	936
Other Personal Loans	816
MSMEs	1064
Memo: Total Increase in Interest Cost in Personal Loans & MSME	
Repo hike 140 bps	1957
Expected Repo Hike of additional 60 bps	839
Source: SBI Research, RBI	

INTEREST RATE HIKES IN INDIA HAS NOT DISRUPTED ROBUST DEMAND GROWTH IN REAL ESTATE

- Interestingly, even as China is grappling with a meltdown in construction sector, housing unit sales in India in H1 2022 (Jan-June have reached the highest level since H12013. Low interest rates and comparatively low home prices along with the renewed need for home ownership sparked by the pandemic, have been the primary drivers for this growth. Growing by 60% in YoY terms, the sale of 158,705 units during H1 2022, was 19% higher than the preceding period of H2 2021.
- Development activity has risen in tandem with the improved demand despite the increasing costs of input material and labour across markets. As many as 160,806 units were launched during H1 2022, a 56% increase YoY. Even in sequential terms, launch volumes were a substantial 25% higher than the relatively unaffected H2 2021 period.
- As of Dec'2021, around 39.2% of the loans are benchmarked to external benchmarks (EBR), so the increase in repo rate of 140 bps will eventually increase interest cost on consumers (Personal Loans & MSME) ~ Rs 1957 per Rs 1 lakh loan in a year and demand of around Rs 50,000 crore may crash during an increasing rate scenario.
- Further, even if RBI increases repo rate by further 60 bps then there would be around Rs 22,184 crore interest cost on Retail & MSME consumers (1 bps increase in repo will have combined impact of ~ Rs 370 crore on Consumers).

India Residential Market (Major Cities)								
CITY	Sales				Launches			
	H1 2022	YOY Change	2021	YOY Change	H1 2022	YOY Change	2021	YOY Change
MUMBAI	44,200	55%	62,989	29%	47,466	32%	70,023	39%
NCR	29,101	154%	35,073	65%	28,726	876%	20,585	110%
BENGALURU	26,677	80%	38,030	61%	21,223	59%	30,607	54%
PUNE	21,797	25%	37,218	38%	17,393	-15%	40,489	16%
CHENNAI	6,951	21%	11,958	38%	7,570	40%	12,783	77%
HYDERABAD	14,693	23%	24,318	142%	21,356	28%	35,736	179%
KOLKATA	7,090	39%	14,405	62%	6,686	205%	7,510	81%
AHMEDABAD	8,197	95%	8,911	37%	10,385	67%	14,648	99%
Total	**1,58,705**	**60%**	**2,32,903**	**51%**	**1,60,806**	**56%**	**2,32,382**	**58%**

Source: Knight Frank , SBI Research

Disclaimer: The Ecowrap is not a priced publication of the Bank. The opinion expressed is of Research Team and not necessarily reflect those of the Bank or its subsidiaries. The contents can be reproduced with proper acknowledgement. The write-up on Economic & Financial Developments is based on information & data procured from various sources and no responsibility is accepted for the accuracy of facts and figures. The Bank or the Research Team assumes no liability if any person or entity relies on views, opinion or facts & figures finding in Ecowrap.

Contact Details:
Dr. Soumya Kanti Ghosh
Group Chief Economic Adviser
State Bank of India, Corporate Centre
M C Road, Nariman Point, Mumbai - 400021
Email: soumya.ghosh@sbi.co.in, gcea.erd@sbi.co.in
Phone:022-22742440
: kantisoumya