# Letter 42

## What about the Chinese market after Evergrande?

***"Happiness rests on unhappiness; unhappiness smoulders under happiness"***

***LAO-ZI*** (6th Century BC)

Since the high in late January, the CSI index of the Chinese market has lost 13% and, at the same time, the US market and European markets have continued to appreciate.

There are several reasons for this divergent evolution :

- Economic, first of all, because China, which was affected by Covid earlier but emerged from the first wave more quickly, took advantage of the disorder caused by production stoppages in the Western world to become more than ever the factory of the world, returning to pre-crisis production levels more quickly than its competitors. The stock market benefited from this with a 2020 performance of 30% for the CSI index, higher than the 18% recorded in the United States and even more than the -1.4% of the EuroStoxx600 recorded in Europe.

- Political, with an ideological stiffening, pressure on the tech giants, an affirmation of the pre-eminence of the Communist Party within companies, an emphasis of the prevalence of the public sector over the private sector, increased threats to Taiwan accompanied by heightened tensions with the United States on trade and on the stock market quotations of Chinese companies on Wall Street, and recently on the theme of "common prosperity" and the will to fight against inequalities.

Today, there are concerns about Evergrande, China’s second largest real estate developer. Many fear a bankruptcy and this is perceptible both in the tensions observed in a bond market with little liquidity and in the stock market performance of real estate players.

To better understand the issues, a 4-point analysis is possible : Is Evergrande a new Lehman? Can the real estate sector continue to grow? If not, what is the impact on the country's economic growth? What are the implications for the markets, the Chinese stock exchange, commodities, currencies and major stock exchanges?

### *I. Evergrande : Towards a solution.*

Let us be clear, Evergrande is potentially the biggest default ever seen in Asia, 200,000 employees, 3 million indirect jobs but Evergrande is not a new Lehman. The latter was "a black swan" to quote the eponymous title of a book by ***Nassim Taïeb,*** while Evergrande is like "the chronicle of a death foretold" to take inspiration from the title of a famous book by Gabriel Garcia Marques.

- **The rise in risk** :

The sword of Damocles of Evergrande has been threatening for months. Moody's had placed Evergrande's outlook on the negative a year ago, Fitch had called it speculative. The company's accounting policies have been criticized.



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The company, with three-quarters of its capital controlled by the founder's family, did not hesitate to buy back shares to boost the share price and offered attractive yields of over 10% on its bonds.

In our monthly brochures, as well as in the international press, the threat of a collapse of Evergrande is analyzed month after month and everyone knows the terms of the problem : $260 billion in debt, liquidity problems, hundreds of projects in more than 200 Chinese cities, 1.4 million pre-sold but not delivered apartments. Today, some of the company's bonds are priced between 15 and 25 cents.

- **Towards a default** :

Clearly, if Lehman Brothers fell by surprise, Evergrande defaulted on a maturity of $83 million but has a period of 30 days to honor this debt or to formalize a default. We anticipate a phased dismantling of Evergrande.

- **A risk to be qualified** :

Some are worried about the silence of the Chinese government, but Evergrande is a private operator which, at one time, drunk with success, has multiplied diversifications and it would not be good to let each of its competitors believe that an automatic rescue is always possible.

Others are alarmed by the amount of debt at risk, but it is important to put this into perspective and reassure. There is $260 billion in debt, but Chinese bank loans exceed $33 trillion, Chinese savings are more than 40% of GDP, or some $7.5 trillion.

There is $20 billion in offshore foreign currency debt, a negligible sum compared to international bond markets, a small sum compared to the country's foreign exchange reserves, $3 trillion, a modest sum compared to the liquidity injection capacity of the Central Bank of China, which has not been used much to date. The BOC has injected $115 billion since mid-September to lower the interbank market rate to less than 1.5% and it could reduce reserve requirements.

- **Between restructuring and dismantling** :

If the impatience of the markets is inherent in their functioning and if the market capitalization has lost 80% to less than $7 billion, everyone will admit it, the disposals of assets, the restructuring of the debt will necessarily take time but have begun. Evergrande’s share price has been suspended, and the sale of 51% of the property management subsidiary to Hopson Development Holdings for $ 4.4 billion has been announced.

Previously, the $1.5 billion stake in a regional bank had been sold to repay the debt with that bank. Soon, the group could also sell its electric vehicle subsidiary and office tower in Hong Kong and local authorities may be encouraged to take over real estate projects. In the end, defaults on some bond lines cannot be ruled out, but the issue will be managed globally.

**In summary**, the Chinese government has not officially intervened and is not explicit in its communication but, obviously, the Chinese authorities are managing this crisis, have control of the largest banks and will not let the banking system fall into a systemic crisis. The confidence of Chinese consumers and investors must not be undermined. The financial reputation of a country with great ambition is at stake, since it is gradually establishing the Yuan as a credible alternative to the $.

## *II. Real estate : towards a structural slowdown.*

- **The real estate boom and its consequences** :

Evergrande is a bit of an iceberg emerging in the ocean of debt in the real estate market, $5.2 trillion according to Nomura, the equivalent of the GDP of France plus the GDP of Great Britain. If ever a country has experienced such rapid development, housing policy has had to accompany this industrial revolution. In two, three decades, the rural exodus has been massive, hundreds of millions of people have moved to the cities. Today the rural population is 25%. It will still decrease but not as quickly.

Today, urbanization affects 900 million people, new cities have sprung up and this has made the fortune of real estate developers and many savers because property represents nearly 50% of household wealth and the Central Bank, at the end of 2020, estimated that 96% of urban households owned at least one home, but the number of empty homes reached 90 million.

As much as house prices in the United States had increased by 80% between 2002 and the "subprime" crisis before falling and then slowly rising, in China, they have increased sixfold since the early 2000s.

- **The crisis is largely the result of a shift in government policy** :

It is no coincidence that the crisis is spreading. Let us remember, in September 2020, the government decided to limit bank loans to the real estate sector, increase mortgage rates, reduce land auctions, and curb the development of large developers. Bank loans to developers have since fallen significantly and the control of shadow banking has been strengthened.

Thus, these measures have been echoed in recent months by the difficulties and increased defaults of several developers, and their inability to issue new bonds to repay the old ones.

We understand the desire to curb the worsening of debt related to real estate, the desire to reduce the dependence of the economy on this sector but the difficulty lies in managing this slowdown without causing too many bankruptcies that are detrimental to employment and confidence.

- **Evergrande's troubles are not an isolated case in the real estate sector :**

Not long ago, the government had to call on state-owned enterprises to bail out developer Huarong after a loss of $13 billion in 2020. Fantasia, a 70th rank minor player in the luxury real estate sector, has also just defaulted on a €93 million repayment. Others also bear high debts. To date, defaults on high-yield real estate debt have exceeded $6 billion.

- **The decline in real estate activity :**

In August, real estate sales in the 50 largest cities, by value, fell by 20% year-on-year. Building starts have fallen by 3.2% year to date and are expected to continue to decline through the end of the year and next year. New home prices are falling. If the decline persists, lending banks could be affected, and homeowners' purchasing power and consumption could be impacted. Indeed, the level of empty house inventories seems less of a problem for developers than for households as many have purchased a second or third home to speculate.

**In summary**, Evergrande's troubles point to the end of an era of rapid growth financed by debt. After the phase of accelerated urbanization, such investments have led to significant overcapacity and construction starts are therefore expected to decline further.

### *III. Growth : Towards the end of the Roaring Twenties.*

Over the three decades of 1980-2010, average annual GDP growth was 10%. In the 2010s, a slowdown was observed. It is expected to be aggravated in the coming years due to the ageing and saturation of infrastructure equipment.

No one can ignore this because China, in recent years, has contributed to one third of global growth and real estate has accounted for nearly 30% of its GDP growth.

If the real estate sector does not maintain the same dynamism, and we do not see how it could be otherwise, then GDP growth will be lower. Let us not forget that the provinces are highly indebted to the extent of more than 50% of GDP and the collapse of land sales, more than 50% of their revenues in 2019, will not improve the situation.

- **The necessary reorientation of the growth model** :

China knows, and it has announced, that it must reorient its growth model from investment, real estate and export to consumption because with 20% of the world's population, it accounts for only 11% of world consumption.

An investment rate of 43% of GDP on average between 2010 and 2019 is not sustainable and there is no comparable example in the world, even if it is financed by a considerable savings rate of 44% of GDP, half of which comes from household savings, 38% of their gross disposable income on average between 2010 and 2019, and the other half through the savings of non-financial institutions.

Notwithstanding the very high level of investment rate, the induced overcapacity, the little or no use of infrastructure, airports, motorways, etc., this overinvestment also poses a problem because it was also driven by a rapidly growing debt :

Household debt, from 25% of GDP for households in 2010 to 60% in 2019, or 130% of gross disposable income, i.e. double the US percentage.

Corporate debt, from 120% of GDP for companies in 2010 to 160% in 2019, double the percentage of debt of US companies.

Beyond the excessive dependence on real estate and beyond the abusive addiction to debt, there are other problems that slow down and hinder growth. Environmental degradation, air, water and land pollution is a structural problem, already examined in Letter 26. Today, there is also the impact of energy shortages. Electricity shortages, blackouts, rationing, thwart the political will to reduce dependence on coal in electricity production, now 60%, and could penalize growth by half a point.

Let us be clear, the whole planet is affected by the record prices of coal, gas and therefore electricity, but China's weight in certain products, coal for example, is such that the replenishment of stocks affects the world market.

- **Increased political control** :

At work, is a public sector favored over the private sector and increased control over private companies. In recent months, we have seen the blocking of the IPO of Ant group’s financial subsidiary, and the sanctions against Didi after its IPO.

The question concerns the dynamics of innovation in a context of increased centralization and control.

The leitmotiv of "common prosperity" could lead to greater control over sensitive sectors such as education, healthcare and real estate. The idea is to promote access for every Chinese, to reduce inequality, to lower costs and encourage families to have more children. In addition, tech companies are incentivized to contribute a portion of their profits to contribute to this common prosperity.

Technological independence remains a key objective and suggests that sectors such as semiconductors, robotics, artificial intelligence, clean and renewable energy will continue to grow rapidly. The goal is to increase productivity gains. The concern is to no longer depend on the United States and possible blackmail or export blockades.

The unknown is the future of Chinese companies listed in the United States and possible restrictions on new listings of Chinese companies in foreign markets. The obvious benefits of better visibility, easier capital raising, higher valuations in the U.S. market are hampered by requests for information from U.S. authorities and concerns about independence from Chinese authorities.

- **The economic slowdown** :

Many businesses are at a standstill because of these shortages. A contraction in the manufacturing PMI to 49.6 in September was recorded after 18 months of expansion and there is a risk of worsening in October, on the one hand because of power cuts, on the other hand, as more than half of the provinces do not meet the targets of reducing energy consumption and expose themselves to the wrath of the government.

Consumption has not been more dynamic recently, only +2.5% in August.

Thus, even assuming further improvement in services, GDP growth could fall to 5% in 2022.

## IV. What are the implications for the different markets?

- **Real estate stocks** :

The entire sector in China is impacted. Thus, in addition to the names mentioned in this Letter, the bonds of Kaisa group holdings lost a third of their value in one week.

- **Commodities** :

A structural slowdown in real estate entails lower demand for cement, copper and steel, all products for which China absorbs 50 to 60% of the world's supply. In other words, the good news internationally would be less pressure on commodity prices. Recently, iron ore prices have fallen to $122/ton, nowhere near the peak in early July at over $220/ton. In the near future, the steel and cement markets are expected to relax as production will have to decline to meet environmental targets and as construction activity slows. Let us not forget that in China, more than 25% of steel consumption, 40% of cement consumption, 20% of copper consumption are in real estate.

Thus, a slowdown in real estate in China will have an impact on the world prices of these products.

- **Rates :**

The Chinese bond market in Yuan represents $19 trillion of which $6.55 trillion are in corporate bonds and $750 billion are in corporate debt in foreign currency according to the International Capital Market Association.

The offshore market in $ reached $900 billion and the offshore market in Yuan, the "dim sum", mainly for the benefit of the financial sector, does not exceed a hundred billion.

Japan's largest fund, GPIF, which has €1.5 trillion in assets, does not want Chinese debt, deeming the market illiquid. The complaint is valid, but the size of the fund is the number one obstacle.

Chinese debt remains attractive. The ratios are no worse than in the major countries, the risk of default is no longer high, but the rates are higher, the correlation to other bond markets weaker, the Central Bank has started to inject liquidity to lower the reserve requirement rate and is expected to lower its rates.

- **The Stock Market** :

Two aspects must be taken into account, the Chinese market and the international markets in their dependence on the Chinese market.

Between 2001 and mid-2021, the Chinese market, MSCI China index, appreciated by an annual average of 12.3% compared to 9.3% for the S&P 500. Compared to the high, the CSI index is at -13%.

Market capitalization, as a percentage of GDP, is less than half that of the United States and is only $14 trillion, $8 trillion on the Shanghai Stock Exchange, mainly for large state-owned companies and industrial groups, $6 trillion in Shenzhen with a focus on smaller companies.

The P/E of the Chinese market is less than 14x. The capitalization of technology stocks in recent months has decreased by $1.1 trillion, from $3 trillion to $1.8 trillion, while it increased in the United States. Thus, the P/E of Chinese internet companies is 29x while it is close to 35x in the United States though the Chinese market is much larger and less competitive.

This observation has prompted the world's leading asset management company, Blackrock, to recommend an overweight position in this market. It should be remembered that before the decline, foreigners held only $800 billion in Chinese securities, including just under $600 billion in bonds and just over $200 billion in stocks. Given that economic growth, even if declining, will remain higher than that of developed countries, in view of the comparative valuations of the markets, weighted by the earnings outlook, and in view of China's low weightage in global portfolios (5% of the MSCI index and more than a third of the MSCI EmergingIndex, but 18% of world GDP), investment in the Chinese market cannot be ruled out. Certainly, the political risk is not absent, and the recovery observed in some sectors and the centralization of power encourage caution but there is room for growth.

The second aspect to be integrated in the investment strategy is the impact of the Chinese slowdown on certain sectors, such as luxury, or certain markets, such as German exports.

***In conclusion :***

**From a cyclical point of view**, there are obvious concerns : a drop in housing starts, a 20% fall in the value of real estate sales in August compared to the same period in 2020, a significant decline in real estate companies on the stock market.

**From a structural point of view**, China still possesses strengths : the size of its domestic market, the development of the middle class, the abundance of savings, the pool of graduates, 8 million additional engineers each year, a figure higher than all developed countries.

**From the perspective of the markets**, as a ***Chinese proverb*** says, ***"It is better to light a candle than***

***to curse the darkness."*** The concern in the markets in general, and in China in particular, is excessive. Temporary are the shortages in a world plagued by chronic overcapacity since low interest rates facilitate the survival of poorly profitable companies, and therefore overcapacity. Temporary should be the disaffection with the Chinese market as the likely announcement of a rate cut or support measures could change investor sentiment if politics does not get involved.

Geneva, 12th October 2021

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