Flash Market Update 21 September 2021

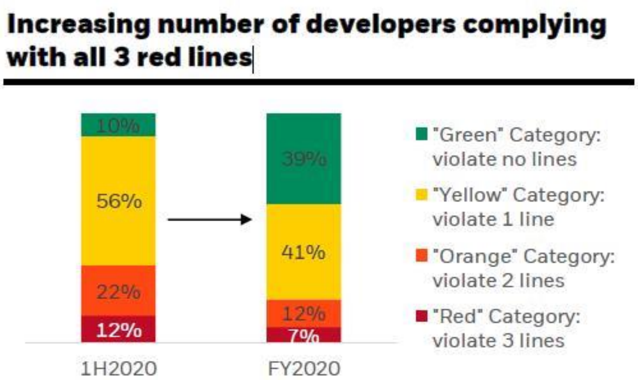
China, Evergrande Contagion?

There have been, for some days now, ominous weather reports of a swirling cloud of doom and gloom known as Evergrande. It is speculated that the potential default of Evergrande on its debt payments could grow into a once-in-a-decade contagion event that would leave in its wake a global economic system in tatters. Sentiment is bearish, with the Hang Seng index dropping close to 5% over the last five days, while the Dow Jones dropped close to 2% yesterday. The purpose of this article is to:

1. provide an objective overview of the situation that cuts through the current climate of fear
2. reassure those who think that we are facing another “Lehman event” (which induced a global bear market), that this situation is different and comes with less dire potential consequences.
3. remind our investors that we have constructed an FVT-driven portfolio. It is designed to tide us through heavy storms and reach that proverbial pot of gold at the end of the rainbow once the clouds lift.

The current Evergrande saga centers on the company’s inability to finance its massive debt obligations to the tune of USD 300 billion. The interest payments have always been a sizeable cashflow obligation. However, in combination with the company’s recent dismal sales, these loan commitments have taken a turn for the fatal. This is a reminder that leverage is a double-edged sword. **This incident also provides a poignant “why” regarding what we do via our FVT process, which is to critically examine a company’s fundamentals (including leverage levels) instead of buying into its headline growth stories.** As a result, we are able to avoid unsustainable growth stories which look good on the way up, but are painful on the way down.

Evergrande’s going under is bad news not just for the company itself, but also for the banks who have lent to Evergrande and the suppliers who have yet to receive payments from the beleaguered company. If Evergrande goes down, it is unlikely that these counterparties will emerge unscathed. There is also a worry that the fall of Evergrande portends a similar fate for the rest of the Chinese real estate industry. Real estate is one of the major engines of China's growth and according to Bloomberg, is responsible for more than 28% of gross domestic output. One can imagine how having one of its largest property developers go under would damage the Chinese economy. However, this sector wide contagion seems unlikely, because Evergrande’s debt situation is not characteristic of the wider sector. Evergrande’s struggling to meet the “three red lines” imposed by the Chinese government is an isolated case. The “three red lines” refer to developer-related borrowing regulations imposed by the state. As seen in the graph below, the red segment represents only a minority of the sector. **The number of bad actors gorged on debt that are now facing their reckoning are limited.**



Source: Blackrock

Furthermore, there are signs that the Chinese government will intervene, at least to the extent of preventing a hard landing for the Chinese economy and its financial markets. This is another reason why we believe that the current situation will not become another "Lehman event". In 2019, the Chinese government took over the distressed Baoshang bank and through deft manoeuvring, managed to avoid a liquidity crisis from arising. While the bank eventually declared bankruptcy, the government's Deposit Insurance Fund provided guarantees for personal deposits and institutional creditors' rights, in an effort to maintain financial and social stability. It is possible that the government will intervene in the same manner for Evergrande. Afterall, regulators in Evergrande's home province of Guangdong have already dispatched accounting and legal experts, including a team from restructuring specialty law firm King & Wood Mallesons to Evergrande. One could see this as the Chinese government laying the groundwork for a restructuring of Evergrande and its debt. The decimation of the Chinese economy and its financial markets due to the contagion effect is not yet a fait accompli.

If we accept that the crisis will likely be limited to a national scale, there might even be second-order benefits to be reaped- as money flows out of China towards alternative emerging markets hitherto unaffected, providing a nice lift for our other positions which will help to pare losses on the Chinese front. **At this point, we would like to remind readers that our positions are diversified across risk drivers, geographies, sectors and asset classes. Even if Evergrande does go under, our portfolios are designed precisely to take such hits.** In any case, we have already divested half of our China 'A" holdings in July this year.

Ultimately, we hope to convey some cautious optimism about the potential of a soft landing without turning a blind eye to the grim realities of the situation. In any case, we will continue to monitor the situation closely and be nimble on our feet if the fundamentals deteriorate.