CPG Research & Advisory Pty Ltd

ECONOMIC & MARKET COMMENTARY

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China's Evergrande Problem

A "Lehman Event"? Or a manageable loss?

Evergrande Background

Evergrande Real Estate Group is China's #2 developer, although actually incorporated in the Cayman Islands. Once the most valuable real estate company on earth, the Shenzhen-headquartered company is lurching towards default after a somewhat self-inflicted liquidity crisis.

When money is tight, there are many things a real estate company could do. *These would not normally include buying a soccer club.* While the club itself was inexpensive, Evergrande then invested heavily in signing players. But the big cost was a new $US1.7bn stadium (twice the cost of Sydney Olympic Stadium)!

That came during explosive growth. Y200bn of assets in 2014 turned into Y2.3tr – far outpacing a tripling of equity to Y350bn ($1 = Y4.7), leaving an undercapitalised group that appears unable to meet this month's obligations.

In an ironic twist, notorious short-seller Andrew Left from Citron was suspended by the HK Stock Exchange in 2016 for a critical report on Evergrande.

Evergrande Creditors

Y2tr of liabilities will need to be haircut, in some form. Some of this is retail money, with Evergrande's financial institution subsidiaries raising "wealth management products" from retail clients.

By August, they admitted they were running out of cash. It has now ***missed offshore bond payments***, with 30 days to cure unlikely to help.

Funds run by Ashmore have $US400m of debt. UBS is owed $300m. These are trivial sums. ***The West faces no measurable direct impact.***

Offshore Bonds

China has controlled capital accounts – money cannot flow freely in and out. Offshore bonds are not the same as onshore. Defaulting to foreign creditors generally results in low recovery, but is not necessarily a default event for onshore.

Onshore bank syndicates claim to hold good security, but mathematically there is not enough collateral to survive a liquidation making everyone whole. ***Offshore bonds will bear the bulk of the costs***, minimising the economic damage onshore.

Evergrande's Scale

Y2tr is around $US250bn. 2% of China's $US14.7tr GDP. That money is not all lost. We assume after offshore bonds default and banks recover collateral value, ***the onshore losses will be ½% of GDP***. China's banks have assets of 300% of GDP, and capital around 28% of GDP. These losses will not bring down the system.

Their annual revenue is also ½% of GDP.

Again, this will not be entirely lost. Either the business will be restructured, or even if they cease operation there are many other that can fill the void.

We expect China will take the opportunity to ease back construction, which has been over-building ahead of their needs. ***This will take up to 0.5% out of 2022 GDP.***

Policy Response

Regulators have been quiet to date, perhaps not wanting to make the situation worse by creating an even bigger panic. But it's not just inaction – it is clear that Beijing is happy to send a message through allowing defaults of the most aggressively leveraged players.

Lehman Bros was such a disaster because the government did not intervene. Rescuing Bear Stearns cost around $30bn. Even $100bn would have been cheap. No doubt, the $700bn TARP would have been needed anyhow, but probably in greatly reduced form. USA would have experienced a mild recession. Instead, banking stopped.

Regulators will need to ensure there is no contagion. If any local banks cannot absorb the loss (which is possible given the concentration of Evergrande's activity in Guangzhou and Shenzhen), a localised bailout will be needed. Shenzhen-based Fantasia is also likely to be default, so **there is a problem in Guangdong**.

We also expect a rescue package for creditors such as contractors, and probably retail investors in the wealth management products. They will be reluctant, given the moral hazard this creates. But retail losses will always be left to "the next one."

We obtained comments from a specialist in non-performing loans and asset workouts in China. Their predictions are as follows:

1. ***What role will Beijing play in an Evergrande restructuring and who will be prioritized?***

The government will step in and oversee one of the largest debt restructurings in history. Priority payment will go to homebuyers, suppliers, contractors, and employees. Senior secured lenders will also receive what they're owed, although large banks will be pressured to extend the maturities of their loans or accept debt-to-equity swaps. Offshore bondholders, especially high yield, will be subordinate to onshore creditors and unlikely to be paid in full.

2. ***Is this a Lehman moment?***

No. A default by Evergrande will neither cause China's financial system to freeze up, nor will it cause the Chinese economy to contract. Banks will continue lending as usual, although some will have to raise fresh capital over the coming year in order to accommodate an increase in NPLs. Meanwhile, economic growth might slow marginally given that Evergrande is unlikely to start any new developments in the coming year. However, Beijing may offset any slowdown by encouraging local government spending. If other developers default, the impact on growth will be more pronounced, but it won't have a sudden destabilizing effect on the economy.

3. ***How will Evergrande affect Chinese real estate markets?***

Government policy in recent years has focused on reducing risk in the real estate market. That has involved reducing developers' leverage, restricting the channels through which developers can borrow, and imposing limits on how much banks can lend toward real estate. Evergrande's problems have been triggered by those measures. Some impact on real estate prices, particularly those sold in a restructuring, is inevitable. But given that this event was ultimately caused by deleveraging policies, Beijing can reverse that if necessary to avoid a sudden crash.

4. ***Does this create a headwind or a tailwind for private credit investment in China?***

This is a tailwind. With the government's continued focus on de-risking and de-levering, there will be greater selection for experienced NPL buyers to source attractive assets. Investors with a platform to invest in onshore credit and the experience with deal selection are well positioned to benefit. Additionally onshore credits offer greater security in the event of a liquidation and higher return potential than offshore bonds.

5. ***What is ShoreVest's experience with developer bankruptcies?***

We have experience enforcing collateral on not only developers, but companies of many other industries. As an example, in the last four years, we acquired and exited NPLs from two bankrupt developers. In both cases we received the full proceeds of collateral auctions in less than 13 months from acquiring the loans, while unsecured debt holders only received partial or no repayment of their principal. Our experience with developer bankruptcies is that courts follow rules that protect senior onshore debt holders. This fact highlights a reality that many offshore funds have failed to understand — that onshore real estate-backed debt (even NPLs) have greater security than offshore bonds in Hong Kong or elsewhere.

We thank ShoreVest for making their commentary available to our clients.

We consider even a disorderly default of Evergrande already priced in by the market. The downside risk comes from the potential of banking contagion (which we do not expect).

Leading Markets

The US Dow Jones, S&P500 and NASDAQ fell -4.3%, -4.8% and -5.3% respectively despite the latter two setting records early in the month. MSCI World ex-AUS slid -2.7% in local terms. Emerging Markets fell -4% in $US with double digit falls in Brazil and Turkey. Japan rose +2.8%. Frontier gained +1.2%.

US 10-year bonds slipped to 1.52% (+22bp). High yield firmed to 315bp spread (-6bp) after retesting post-GFC tights.

Other Highlights

COVID19 deaths passed 4¾m (+¼m) from 235m cases (+17m). The US FDA overwhelmingly rejected a booster plan 16-2, with the world at 34% 2nd shot.

World leaders converged at the UN.

The US Administration pushed an expanded $3.5tr "infrastructure" package after bipartisan support for $1.5tr.

GDPNow guides under +1% (+3.7% p.a.) for Q3, below consensus and downgraded sharply in the month.

US unemployment fell to 5.2% (-0.2%) in August, with Non-farm Payrolls a modest +235k. Youth unemployment soared to 9.9% (+0.7%).

Inflation eased to +5.3% YoY (-0.1%) after a +0.3% month *vs* +0.5%. Core inflation was +4% *vs* +4.3% in July. Retail sales rose +0.7%.

Eurozone unemployment improved to 7.6% (-0.2%) in July. Prices rose +0.4% in August and are +3% YoY. Core inflation jumped to +1.6% YoY from +0.7%. Q3 growth is forecast at over +3%, in stark contrast to a fading US recovery.

The ECB held its annual forum.

US-France relations were damaged by the role of USA in launching the AUKUS pact. The French reaction partly reflected impending elections with UK also likely to be targeted.

UK bond yields reached post-COVID high of 0.96% as inflation hit 3.2% from 2%.

China planned for an imminent default in the massive developer Evergrande. They targeted Australian exports with a reduction in steel production.

Domestic

The RBA's *Minutes* spoke of a broad-based moderation in the global recovery, at a time of more persistent inflation due to supply chain interruptions. They expect only moderate retracement in commodities from a record, as coal cushions the effect of plunging iron ore.

Short-dated bond yields grossly undershot the RBA's target as QE purchased bonds. A slower than planned taper of QE reflected the current contraction.

Demand remained strong for major bank paper.

NSW' outbreak peaked around 1500 daily cases, with Victoria now setting *per capita* records.

The month closed with ~79% first or second COVID19 shots for ages 16+, up from 59%, with the 80% target now projected for Nov 6th (a week late).

The ASX200 declined -1.9% and the Small Ordinaries -2.1%. CoreLogic reports +1.5% housing gains in September. YoY, leaders were Sydney houses (+29%) and Hobart units (+31%)!

10-year bonds slumped to 1.49% (+30bp).

August unemployment fell to 4.5% (-0.1%) on 65.2% participation (-0.8%). Employment dived -146k (-68k fulltime). Underemployment soared +1% to 9.3%. Youth unemployment rose to 10.7% (+0.5%). The population grew +0.1% YoY.

Household wealth was a record $13.4bn (+5.8%), crossing $½m *per capita*. Residential property gained +6.8% in Q2, a record +16.8% YoY.

July's trade surplus was a record $12.1bn.

Retail trade fell -2.7% in August.

Commodities and Currency

WTI oil soared to $US75/bbl (+9%). Gold fell to $1752/oz (-3.5%). Iron ore dived -30% to $110/t, half its July peak. But thermal coal extended its records, closing $218/t (+27%).

Base metals Tin (+5.1%), Aluminium (+5.0%) and Zinc (+0.6%) gained while Copper (-4.5%) and Nickel (-6.9%) fell.

The $A eased to US72.06c (-1.8%).

KEY FINANCIAL MARKET DATA – AS AT 30TH SEPTEMBER 2021 (UNLESS SPECIFIED)

Interest Rate Markets

Index Performance	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
AustBond Bank Bill Index	0.00%	0.00%	0.01%	0.04%	0.31%	0.79%	1.20%

Key Rates	Sep-21	Aug-21	Jul-21
Australian Cash Rate	0.10%	0.10%	0.10%
90 day BBSW	0.02%	0.01%	0.02%
3 Yr Commonwealth Bonds	0.25%	0.24%	0.25%
10 Yr Commonwealth Bonds	1.49%	1.16%	1.19%
CDX North American 5 Yr CDS	54bp	46bp	50bp
iTraxx Europe 5 Yr CDS	51bp	45bp	47bp
iTraxx Australia 5 Yr CDS	70bp	58bp	63bp
US Fed Funds Rate	0-0.25%	0-0.25%	0-0.25%
US 10 Yr Bond Rate	1.52%	1.30%	1.24%

Equity Markets

Domestic	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
S&P/ASX 200 Acc. Index	-1.85%	1.71%	10.14%	30.56%	8.27%	9.65%	10.42%
S&P/ASX Small Ord Acc. Index	-2.14%	3.44%	12.23%	30.41%	12.28%	9.43%	10.18%
S&P/ASX 200 A-REIT Acc. Index	-2.18%	4.24%	15.14%	29.85%	4.03%	8.57%	7.10%

International	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
US: S&P 500 ($US)	-4.65%	0.58%	9.18%	30.00%	22.35%	15.99%	16.90%
US: NASDAQ ($US)	-5.27%	-0.23%	9.43%	30.26%	35.50%	22.67%	23.37%
MSCI World Acc. (Local Currency)	-3.72%	0.58%	8.18%	29.02%	18.61%	13.03%	13.87%
MSCI World Acc. (AUD)	-3.05%	3.99%	13.69%	27.76%	15.44%	13.30%	15.18%
FTSE 100 (£)	-0.16%	1.96%	7.73%	25.36%	1.34%	1.97%	4.58%
MSCI Emerging Markets ($US)	-3.97%	-8.09%	-3.45%	18.20%	14.31%	8.58%	9.23%

Fixed Interest Markets

Bonds	1 month	3 months	6 months	1 year	2 year p.a.	3 year p.a.	5 year p.a.
BarCap Global Agg Acc. (AUD)	-0.62%	3.01%	5.88%	-1.68%	-0.86%	4.30%	3.18%
AusBond Composite Bond Acc.	-1.51%	0.31%	1.84%	-1.54%	0.81%	4.14%	3.06%
ICE BoAML High Yield TR ($US)	0.03%	0.94%	3.74%	11.46%	6.78%	6.62%	6.35%

Data*	Current Period		Previous Period	
Employment Data				
Employment Growth	August	-146,300	July	2,200
Unemployment Rate	August	4.50%	July	4.60%
Participation Rate	August	65.20%	July	66.00%
Lending Finance				
Housing Finance	August	-4.30%	July	0.20%
Personal Finance	August	-2.50%	July	14.20%
Business Finance	August	-26.40%	July	56.00%
Other				
Balance on goods and services	August	15,077m	July	12,117m
Retail Sales	August	-1.70%	July	-2.70%
Building Approvals	August	6.80%	July	-8.60%

*All data is seasonally-adjusted.

For any queries, please contact:

Name	Title	Phone	Email
Andrew Vallner	Chief Executive	(0416) 02 9271	andrew.vallner@cpgadvisory.com.au
Vipul Gupta	Advisor – Fixed Interest	(0435) 756 721	vipul.gupta@cpgadvisory.com.au
Rick Lu	Senior Analyst	(0424) 497 503	rick.lu@cpgadvisory.com.au