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China Evergrande: Catalyst for a correction or a bear market?

China Evergrande (3333 HK), China's second largest property developer by revenue (and 122nd largest company globally), is saddled with USD 305 billion debt. Its deleveraging process has been in train for well over 12 months—but there are serious doubts about its solvency, with Evergrande due to pay USD 83.5 million in interest relating to its March 2022 bond on Thursday.

It has another USD 47.5 million payment due on 29 September for its March 2024 notes, and its share price has fallen approximately 93% from its June 2020 highs, while its 8.75% 2025 bonds are currently trading at less than 25c in the dollar. Until recently, contagion has been limited to emerging market equities, but there is a risk that this may spill over to other asset classes, potentially resulting in a broader equity market correction (i.e. >10% fall), although we see a bear market as unlikely at this stage.

An orderly deleveraging of the Chinese property sector

In many ways, Evergrande's woes are emblematic of China's "line-in-the-sand" moment. Over the years, the distinction between financial and social stability has become blurred, resulting in Beijing stepping in to bail out a variety of institutions (e.g. Huarong Asset Management, HangFeng Bank, Baosheng Bank, Jinzhou Bank). In many ways, this "moral hazard" is the same problem that confronted US and European regulators during the GFC. Bailing out Evergrande risks industry participants viewing it as an implicit acceptance of risky behaviour and a government backstop should they run into difficulty. However, this is the antithesis of what the Chinese Government has been trying to achieve over the past several years (since 2016 in fact)—that is, an orderly deleveraging of its real estate sector. In fact, it was only last year that China introduced its "Three Red Lines" policy dictating leverage limits on real estate developers. Consequently, authorities have been quiet on Evergrande's financial difficulties, giving rise to the prospect of an Evergrande bankruptcy. The Government's reluctance to initiate a blanket easing of property market policies over the past year, despite softer economic growth, demonstrates increased willingness to reduce China's dependence on the real estate industry as an engine of growth. This aligns with the Government's longer-term goals of preventing the build-up of financial risks in the property market (for example, due to leveraged housing purchases) and fostering a rebalancing of economic growth away from investment.

Evergrande is a complicated matter though—not least of all due to the country's "seniority waterfall", which will govern who gets paid first in the event of a default (i.e. the Government). Combined with the ~1.7 million people who have deposited down payments for Evergrande homes that may not get built, the 3.8mn contractors/suppliers that Evergrande works with, the ~125k employees who may lose their jobs, the almost 300 banks and financial institutions that Evergrande owes money to, and the systemically important role that property plays (not only in the Chinese economy, but the global economy), and the way that Evergrande is handled will have important implications for global financial markets.

Could a credit event from Evergrande impact the broader economy?

Investors are concerned that a credit event stemming from Evergrande could spill over to other developers, suppliers, the financial system and the overall economy. We are seeing some signs of risk spilling over into other asset classes, most notably the broader China high yield market (Chart 1) and equity sectors considered most exposed to property (Chart 2)—particularly the real estate sector. The risk of incomplete or delayed projects by Evergrande may mean that future homebuyers may be more selective on the developer for their home purchase, which would further amplify the current liquidity cycle and confidence in the sector. An Evergrande bankruptcy would quite significantly impact property sentiment. If there is no government relaxation on the property sector or Evergrande bailout, homebuyers could become more sceptical on other developers' capability to complete their properties. Banks and bond investors could be more sceptical to lend or roll over their debt, leading to a spike in interest rates.

Equity markets are showing increasing signs of nervousness

At this stage, there has been limited evidence of contagion in investment grade spreads (trading close to their lows), the currency, or the sovereign bond market. Given the importance of the property sector in the overall economy and financial system stability, it requires monitoring. Equity markets, however, are showing increasing signs of nervousness about the prospects that a systemically important company may be allowed to fail, or that its resolution may first become disorderly.

Could Evergrande risk spill over into global financial markets and cause a correction, or even a bear market? Our central thesis is that an Evergrande bankruptcy could be a catalyst for a recalibration in risk taking and cause a correction (i.e. >10% fall in global equity markets). Whether it becomes the catalyst for a genuine bear market (i.e. >20% fall) depends on how disorderly a bankruptcy might become—and, at this stage, this is not our central case.

Importantly, most of Evergrande's offshore bonds are not held by banks or other financial institutions. Furthermore, there is a recovery value associated with Evergrande, given it has tangible property assets. These are subtle, yet tangibly important factors that may mitigate contagion to other financial markets. Nonetheless, one should not underestimate just how systemic the Chinese property sector is to the global economy. Importantly, the People's Bank of China has the means to avoid a systemic liquidity squeeze, and if the Government can manage a smooth restructuring, it could actually bolster investors' and creditors' confidence in the future sustainability of China growth.

A 2019 bulletin published by the Reserve Bank of Australia (RBA) sheds light on just how important the Chinese property market has been to world and Australian growth. Housing investment has contributed significantly to Chinese growth in recent decades and, due to the steel-intensive nature of that investment, has also been an important driver of Australian exports of iron ore and metallurgical coal. Trends in Chinese residential investment have been strongly influenced by government policies. Private property markets continue to be strongly affected by government policies, many of which are periodically changed (2007, 2009, 2013 and 2016) to affect the demand for (and supply of) housing to help smooth economic growth and temper large swings in housing prices

According to the RBA, China's housing policy cycles have had "non-trivial effects on GDP growth due to the wide range of upstream and downstream industries that facilitate construction and sales (including steel, cement, glass, household fittings and financial services related to housing)". Based on RBA analysis, combining the direct and indirect effects of real estate investment on activity, their estimates suggest that, on average, from 2003 to 2017 real estate investment contributed 2 percentage points to China's economic growth—that is, just over one fifth of the average increase in real GDP. China's own estimates have put it even higher, at 30%, including upstream and downstream linkages (this is much higher than the US at 15%). In a world where China represents around 18% of global output this is significant. Furthermore, if Evergrande uncertainty were to lead to a tightening in risk appetite and a spike in lending rates, its flow-on effects would be material.

For now, investors will be focused on whether Chinese authorities view Evergrande as "too big to fail". That is, will they blink first and structure a solution that allows for an orderly unwind of Evergrande, thus limiting a loss of faith in arguably China's most important industry? History suggests that they will, but it is far from certain.

We continue to favour positioning portfolios moderately risk-on

Investors should be cognisant of their tactical and strategic asset allocations when considering the above. We continue to view this, along with other potential uncertainties such as the US fiscal debate and passing peak growth, as potential catalysts of short-term volatility. However, looking ahead to 2022, we continue to expect the global economy to normalise at a healthy pace, as vaccination rates rise to levels that remove the risk of renewed severe mobility restrictions. As such, and together with early stages of central bank normalisation that will increase through 2022, we continue to favour positioning portfolios moderately risk-on, favouring equity returns over fixed income returns, and with full allocations to alternative assets.

Chart 1: China high yield index

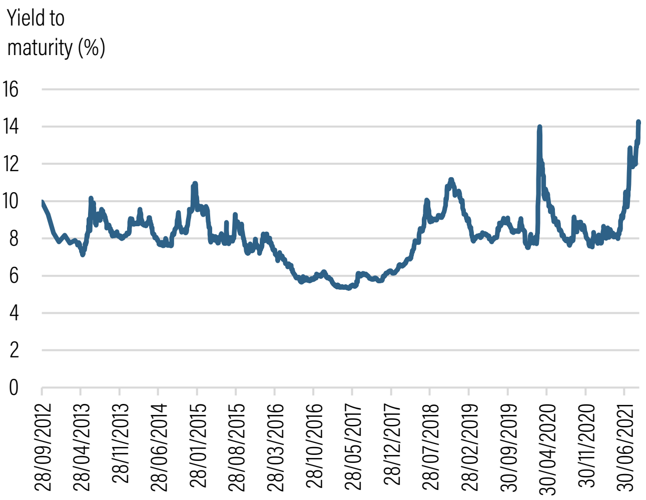
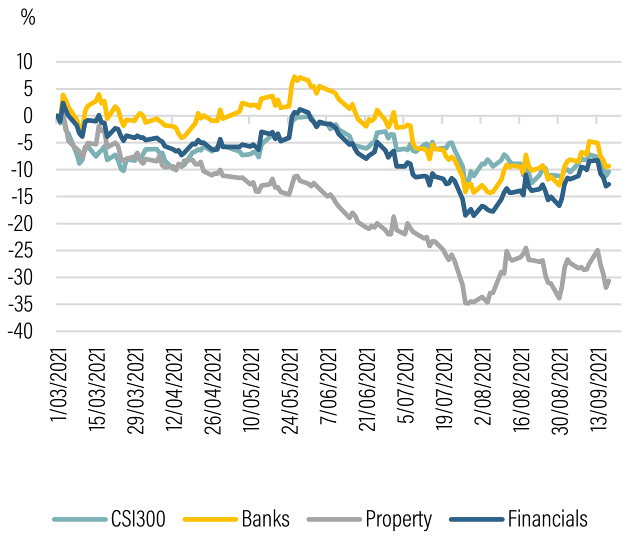


Chart 2: Chinese equity sectors exposed to property



Source: Bloomberg.

IMPORTANT NOTE