Private Bank

Global Strategy Bulletin

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Long-Dormant Fear Revives: China Property Risks Small Relative to Global Capacity to Absorb

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- **Global financial markets were rocked overnight with a highly correlated selloff across the world. Global equities fell about 2.0% with all regions and 10 of 11 sectors negative. The ostensible catalyst was the well-telegraphed news that Chinese property developer Evergrande would not make loan payments today.**
- **The larger setting of "absent volatility" and heightened macro policy uncertainty seems critical background for today's market action. The US equity market hasn't experienced a drop larger than 4% in the year-to-date. Corrections of 5% have occurred 3X on average in annual periods of the past 70 years.**
- **Evergrande's bonds have fallen precipitously since May, to about 30% of their par value. Shares have fallen all year long. However, suspense over a Federal Reserve meeting Wednesday, the US fiscal drama, and moderating economic growth have culminated in a round of risk aversion and profit-taking for shorter-term traders.**
- **Evergrande has $14 billion in external bonds, $9 billion in onshore bonds and $66 billion in bank loans, with the majority of this borrowing from domestic Chinese banks. The scope of direct financial losses from an Evergrande default could be easily absorbed by available risk capital and central government resources.**
- **However, Evergrande's woes can be linked directly to Chinese macro policy, including strong restrictions on housing developers. This weakness can now be seen in a severe erosion of financial conditions for most of the nation's property developers, pointing to an economic slump in the sector.**
- **If Chinese authorities tolerate this level of financial woe for the housing sector without compensating macro-level easing, it will signal deteriorating overall growth prospects for China, with spillovers to the world economy. Markets will watch actions from Chinese authorities closely in coming days.**
- **As examples of assets with negative exposure, iron ore futures fell 4% today with China's trading partners such as Germany, Australia and Brazil seeing negative spillover in equities markets and/or foreign exchange.**
- **Asian markets (including China) were closed for a holiday Monday, exacerbating liquidity issues for investors scrambling to address Evergrande. In the US, implied volatility has spiked, with the cost of downside protection particularly high versus upside exposure in derivatives.**
  Comment:
- **The probability seems high that investors will overstate Evergrande risk after strong market gains in 2021. This is partly because of building US policy uncertainties. However, If China acts to contain macroeconomic fallout and the Fed doesn't surprise markets with a hawkish policy turn this week, we believe a sharp rebound in markets could follow a near-term sharp decline.**

Contagion in Markets Revives After Long Absence

More than a year after global central banks and finance ministers managed the massive feat of separating the financial market outlook from the path of the COVID pandemic, world markets suddenly show hints of a new "contagion."

Global shares fell in most every open market, and in every sector Monday. Currencies and commodities plunged on news that was already apparent last week: Chinese authorities – who have taken steps to intervene in its troubled, second-largest property developer – alerted counterparties that Evergrande would not be making interest payments today.

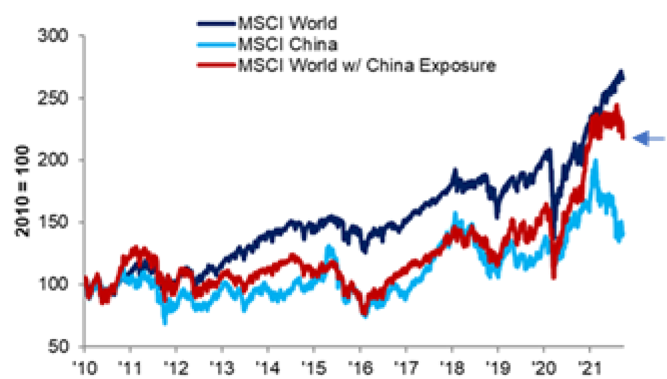
As figure 1 shows, Evergrande bonds have been plummeting since May. In the past two months, other leveraged Chinese property bonds have weakened on the same underlying situation – tightening regulation and credit constraints for the property sector. China is prioritizing affordability over growth and profitability for its builders. The property restrictions add to a long list of regulatory concerns that were idiosyncratically priced into particular Chinese entities who didn't fit favorably into Chinese economic planning (Please see Asia Strategist September 2nd).

Today, however, the plunge in most global assets finally shows strong markings of reduced growth expectations for China in a broad-based way (see figure 2). This has spillovers for the world economy, where capital goods exporters (Germany) and commodities exporters (Australia and Brazil) saw significant market impact.

Figure 1: After Evergrande default was priced in, spillover to other high yield issuers broadened to even to the less leveraged

Source: Bloomberg, Citi Velocity as of September 20, 2021

Figure 2: Now, larger global markets have suddenly reacted



Source: Bloomberg as of September 20, 2021

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China Macro Policy: Increasingly Inconsistent with Growth Goals

What is worrying global investors is an apparent willingness of Chinese authorities to sacrifice growth to squeeze the real estate sector to a point of a broadening spillover, not just within the sector, but also the larger financial industry. This is challenging our view that the authorities prioritize financial stability and have the means to "ring fence" the spillover.

A plan appears to be in the making for resolving the Evergrande issues. First, the Ministry of Housing and Urban/Rural Development is handling the completion of unfinished projects to avoid social unrest among Evergrande's customers. The nation's top financial regulator under the State Council is managing the firm's impact on the financial system. A group of China's banks has been assembled to provide financing to address both of these issues. Similar to the earlier and much more critical case of Ministry of Finance-owned debt consolidator Huarong, the intention is to wind down the size of the problem to be "small enough to fail or be consolidated."

Since Evergrande bonds fell below 30% of face value, they have been range bound. More recently, other issuers in the property sector started to take the brunt of selling. Moreover, banks and insurer shares have been hard hit in the recent weeks amid the real estate rout, joining ranks with Macau gaming and tech who have suffered China policy-related hits earlier. We believe the market is telling regulators that unless something is done to stop the spillover, more issuers will face default risk.

Markets will watch Chinese policy actions closely in coming days. Evergrande has roughly $120 million in interest payments due this week alone (Bloomberg). This is not a prohibitive cost to avoid deeper financial stress in China. How it is handled, however, will provide a signal as to how private credit risks will be managed by authorities. For example, If completing unfinished projects is a top priority of China's policymakers, then it would be counterproductive to create more unfinished projects by pushing more developers into liquidity crises. This would impact Chinese labor markets by inhibiting payments for contractors.

Containing fallout from Evergrande appears no longer sufficient at this stage. China's economic growth faltered in August. Retail sales grew only 1% annualized over the past 24 months, partly due to Covid, partly to floods, but significantly due to credit tightening. Sales are unlikely to rebound naturally in September because pandemic restrictions have tightened further. The lack of consumption support means fixed asset investment (FAI) needs to pick up more slack for China to exceed its minimum growth targets. Property development accounted for 35% of total FAI so far this year, and actually grew at 12% in the first eight months, exceeding the 8.9% total. Losing this engine of growth could mean sub-6% growth in 4Q. As a result, broader policy easing is required.

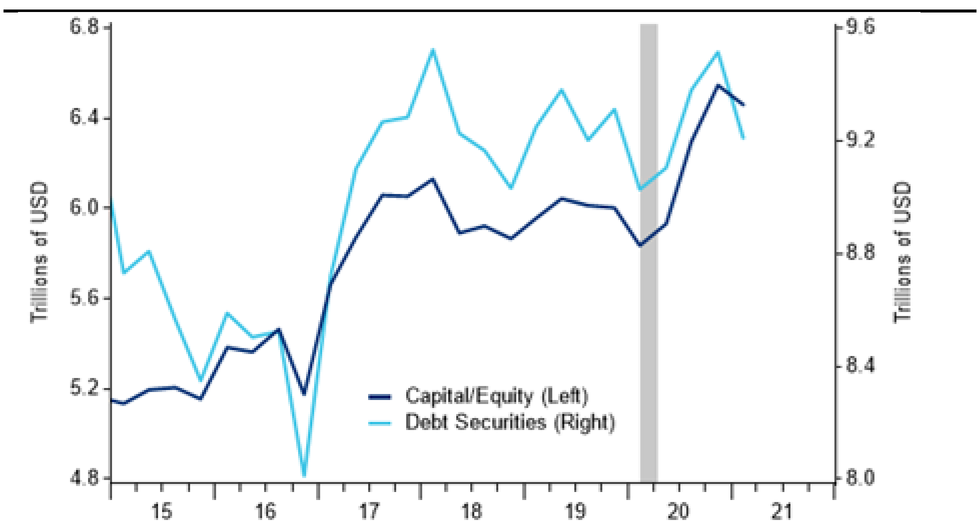
We continue to believe that Chinese authorities have the ability and desire to limit economic weakness. China's highest policy officials argue that common prosperity requires relatively robust economic growth, or else the middle income populations would not grow and social stability would be harder to sustain.

Spillover for the Rest of the World: Easy to Exaggerate

If kept in isolation, the world's financial exposure to Evergrande – and even the entire Chinese property sector – would actually be an easily manageable shock. Consider for a moment the impact of COVID-19 dislocations in 2020. The US financial sector posted less than a 25% drop in EPS, giving it the second most profitable year since 2006. This occurred during the sharpest (if shortest) economic contraction in history.

As figure 3 shows, global banks reporting to the Bank for International Settlements (BIS) have increased their risk-absorbing capital to $6.5 trillion in recent years (note: BIS data exclude China). Data following the Global Financial Crisis already showed the largest de-risking of liabilities relative to bank capital in observable history. Federal Reserve and ECB stress tests show low vulnerability in line with this.

Figure 3: Global Bank Capital vs Debt Liabilities



Source: Haver Analytics through September 20, 2021 Shaded areas represent recession.

However, fear is a far more potent force than Evergrande's $14 billion in external borrowing. Apprehension over Federal Reserve credit policy was already high coming into this week. The prospect for a US debt ceiling fracas – coupled with tax hikes – is far from a "risk motivator" (please see our latest CIO bulletin for more). The slowdown to "sub 4% real GDP growth only incentives short-term traders to take profits (see figure 4).

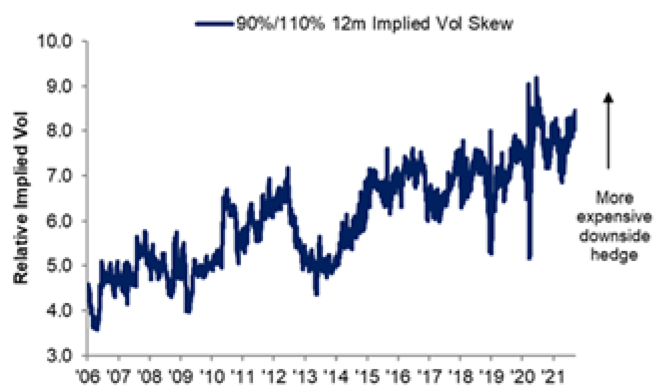
However, these are far from signs of a major business cycle turning point. Rather, markets are now suddenly doubting the strength of the potential growth outlook ahead. This can be seen in a 34% jump in S&P 500 implied volatility today coupled with already high options premia for downside hedges compared to upside exposure (see figure 5).

We've argued that the big "bounceback" in the economy from the COVID shock has passed. We have realigned equity portfolios for more sustainable sources of returns, such as favoring Healthcare over Cyclical areas. With market losses overall small in historic scope so far, and a correction could gather speed. However, **markets are now selling off assets that have little or no sensitivity to China's economy** (see figure 6). This can create potential opportunity. History shows the deepest daily declines and gains tend to be clustered closely together (see figure 7)

Figure 4: Atlanta Fed GDP Now vs Actual GDP Growth

Source: Haver Analytics as of September 20, 2021

Figure 5: Implied Volatility Skew of 10% out of the Money S&P 500 Puts/Calls for 12 months



Source: Bloomberg as of September 20, 2021

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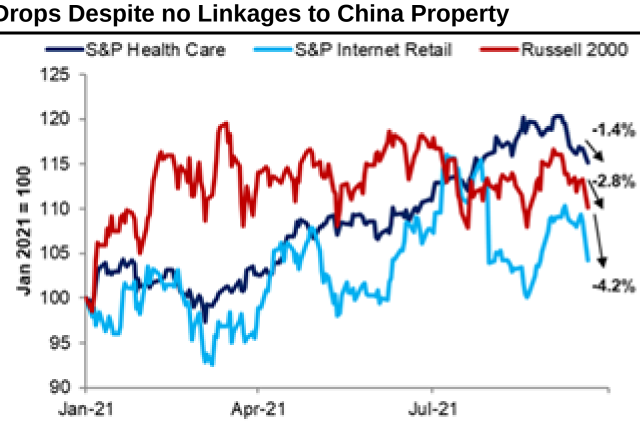
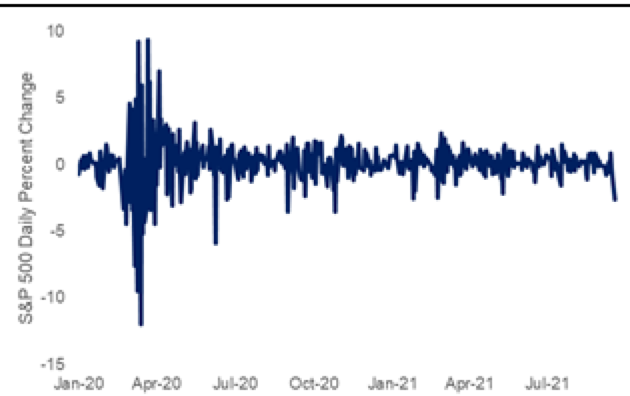
Figure 6: US Small Caps, Healthcare and Internet Show Deep Drops Despite no Linkages to China Property



Source: Bloomberg as of September 20, 2021

Figure 7: The Largest Daily Gains and Loses Tend to Occur Close Together in Every Market Setting



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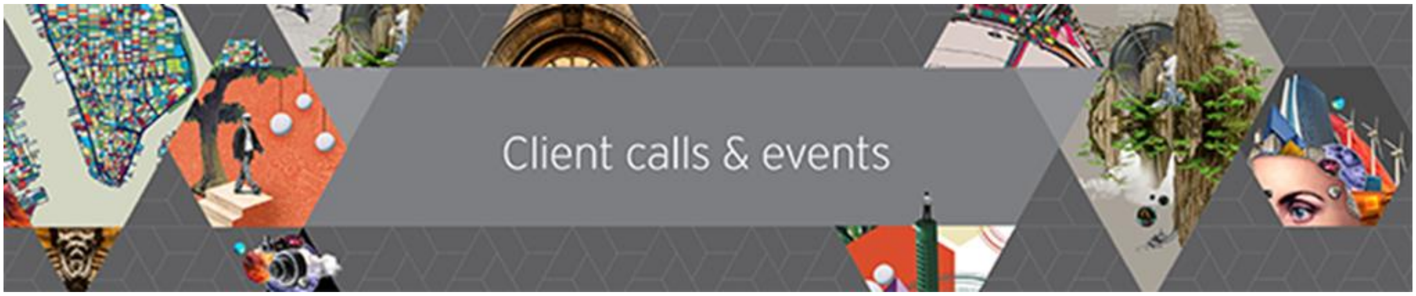

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