

## THE BIG PICTURE OF GLOBAL ECONOMICS

GLOBAL CIO WEEKLY BY GARY DUGAN



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## Not So Evergrande

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## Evergrande in focus: Avoiding China's Lehman moment

It's more than just a stack of numbers: Newswires have filled up this past fortnight on the plight of Evergrande, the failed Chinese property developer. The firm has large outstanding commitments, ranging from bonds issued in the USD market to loans with banks, promised deliveries of properties to customers, and the so-called wealth management products (WMPs). WMPs are held by private investors, with the payoffs tied to the delivery of finished homes. The reports have detailed the numbers in all of these categories, but the specifics are no longer the issue. Yes, the numbers are big but the point is this: the system is at risk unless policy action is taken. Left to its own devices, a market-driven solution could cause serious systemic damage.

Emerging priority for support: (1) market functioning, (2) depositors, (3) contractors, and (4) bondholders.

**Market functioning:** The announcement on Friday that the PBOC will add liquidity to money markets soothed growing fears that the normal working of the market will gum up. This comes as participants become worried that there are more shoes to drop. However, there may still be nascent signs that Evergrande is not the only entity with cash flow problems. It seems that oiling the wheels pre-emptively may be a necessary step to avoid a sudden stop.

**Social focus suggests bailing out depositors:** While Evergrande is not a bank, it has a large base of depositors. They have paid money and, in return, await properties that have yet to be delivered. In a worst-case scenario, the depositors will lose everything (some have effectively pre-paid for their entire property already) if Evergrande stops operating. The government would likely step in to ensure that depositors, estimated at about 1.5 million, are made good or given assurances that the properties paid for will be completed and delivered.

**Contractors and operations:** To ensure that depositors (future homeowners) are protected, it might turn out to be necessary to provide assistance or a bail-out to the contractors and operating entities involved in the physical construction process.

**Bondholders are not sitting pretty:** With only around \$15 billion of cash on Evergrande's balance sheet, the bond market has rightly priced in a dire outcome for bondholders. By Friday, the bonds of the company were trading in at around 30 cents to the dollar. The company has already announced it will skip the next interest payment due this week. The missed payments will trigger cross-default language across all other bonds. They will thus potentially set off a default on all outstanding bonds if the company cannot rectify the situation within the 30-day grace period.

In beating contagion, time is of essence: The market is signaling its concern in the broader context, too: spreads on Chinese high yield debt have spiked above 15%. To get ahead of the situation, authorities will have to act decisively and soon. At the height of the COVID sell-off, the spread between Chinese high yield and government bonds reached 1643 basis points. Quick containment is essential. Otherwise, we can expect that the sheer scale and complexity

of the situation will become perhaps too big to deal with later.

The question of contagion leads to another pertinent question that the market will be asking: who is next? Last year, authorities issued the “three red lines” directive to regulate the activities of property developers in China. In hindsight, it may now be interpreted as the government’s first warning to the industry to clean things up. It may have come too late for Evergrande, but some other firms will be scrutinised in the context of overall debt on balance sheets, as well as their ability to cover the short-term debt with cash. If uncertainty starts to swirl around one or more other entities, a swift resolution to the Evergrande issue will become all the more pressing.

**Market action in early trading in Asia suggests very strongly that the situation is threatening to run out of control.** Property stocks in Hong Kong are down more than 5% as we go to press and there are clear signs of systemic risk in the broader market. The shares of banks and insurance firms are under pressure too. Chinese high yield bonds have already taken a lot of strain, but current spread levels could widen significantly if there is a broader and continued loss of confidence. The previous highs for spreads might be exceeded quite soon.

**For now, Chinese government debt seems to be relatively stable.** The market view is that even a full consolidation of the Evergrande debt will not cause serious deterioration to the quality of sovereign debt. However, to repeat, time is now of the essence. Further delays by the authorities in coming up with clear and decisive policy and support measures will allow the crisis to spread into more market sectors and open the door for damage to the real economy.

Chinese asset markets remain in a state of flux and are much in need of a significant boost from either monetary or fiscal policy interventions. However, for the moment, it appears the authorities want to move in a measured way. Previous attempts to stimulate the economy through lax fiscal policy have only exacerbated the imbalances such as the leverage and speculation in the property market.

**.....And Finally the Fed**

**There is an important, potentially market-moving Fed meeting scheduled this week.** The market expects further Fed talk on a likely start to a tapering of its quantitative easing policy from November. However, the market may be more interested in new forecasts from the Fed board members on the potential path of interest rates out to 2024. With the bond market coming off a poor week that saw yields higher across the board, interest rates moving up and down could lead to a further drift higher in the US 10-year yield.

The dynamics across the Fed board are also worth watching. There is increasing evidence of a 50-50 split between the hawks and the doves. Many Fed board members believe that inflation is normalising at close to the central bank’s target while an equal number think that the spike in inflation is transitory. For the moment, the doves probably have Chairman Powell on their side and just about hold the majority. However, if inflation is above the Fed forecasts by the turn of the year, the central bank may have to speed up its tightening. Despite the recent weaker-than-expected global economic activity, there is still evidence that global inflation is much more persistent and widespread than many on the Fed board had expected.

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