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MARKET
QUICK TAKES

Evergrande Is Not China's 'Lehman Moment'

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We wanted to start a video blog series where we can respond more real-time to issues we're seeing in the market, questions we're receiving from clients or different investment ideas that we're seeing from a day-to-day basis, something a little bit more in real time.

So, today, the news of the day or news of the last few weeks has been the Evergrande bankruptcy or the pending bankruptcy in the Chinese property market. And one of the questions we're receiving is "Is this China's 'Lehman moment'?" or "Is this their 'Minsky moment'?" if you will.

And our short answer is No, that this isn't some systemic shock that we're waiting to see ripple through global markets. And one of the key differences is the fact that this has been very well telegraphed. Going back almost a year ago, China began publishing what they would call their three red lines for the Chinese property sector and trying to highlight the excesses and the excess leverage that was the building in the system and communicating that they were no longer planning on supporting all ends of the property market and that ultimately those better capitalized and less levered companies would likely survive and that there could and will be defaults.

And that's what we're seeing today. And as a result, this was somewhat planned if you will, and this is something that we've kind of seen coming for a little bit of time now. And as a result, I would probably compare it more to a Long-term Capital Management-type crisis or issue like we saw in the 1990s with the Russian debt crisis where there very well could be some unintended consequences.

Anytime you get these sorts of volatile situations, you end up with some whales that float to the surface. So, it's very likely that we see a big player or two that didn't anticipate China to actually follow through on what they said to have some ramifications.

But as far as this being a broader systemic crisis, we would take the other side of that. Ultimately, the banking sector has been preparing for this. And we believe they're capitalized, and this is something that is of China's choosing. They're choosing to let the credit markets start to price in real credit risk. And as a result, that's going to create some near-term volatility and uncomfortableness for market participants. But, ultimately, it gets them to a better place on the other side where risk starts getting priced into the market a little bit better.

On that point, there are two things that we'd watch for to start becoming more concerned that maybe this is getting out of hand, and they do not have control over it. One would be the Chinese yuan and how it acts relative to other major currencies, specifically the U.S. dollar. Looking at that currency throughout this entire time period, it's been relatively flat, stable, appreciating until recently, actually, relative to the dollar, and still up on a year-to-date basis.

So, if you were to see some sort of sharp depreciation or significant change in trend similar to what we saw in 2015 when we saw the devaluation of the currency there, then you might get a little more concerned that they don't have it all under control, if you will, and that things are kind of getting away from them.

The other data point to monitor is the spreads that we're seeing in the investment grade in the sovereign market, which continue to be relatively stable and calm throughout the Chinese market. We have seen high yield spreads start to widen, or they've been widening for a few months here. And that makes sense, given the stress to the property market and the spreads you'd expect for these companies that may end up ultimately defaulting.

So, how do we think this issue ultimately resolves itself? I think the most likely outcome is that there's an orchestrated restructuring, that ultimately we have some very well capitalized players within the property market able to buy Evergrande and maybe other developer assets at pennies on the dollar, and that ultimately strong hands come in and can take over these properties and finish these projects or ultimately operate these projects and that the market becomes more consolidated. And, a lesson has been learned for the use of levers throughout the sector.

On the other hand, I'd say as far as property prices are concerned, China is very concerned with property prices. They do believe that prices have made the affordability of housing unrealistic and would like to see that trend kind of slow down. With that being said, the property market is a huge store of value for the Chinese citizens. As a result, I don't think there would be much desire to see a significant correction across property pricing. I think if anything, it's hopefully more slowing down the ascent and maybe some stabilization or some near-term correction here.

I equate the Chinese property market to the U.S. equity market where we feel as if there's kind of this Fed hand to support the markets. Whenever there's a larger correction, you get some easing talk and kind of calming of the market. It's very similar to the Chinese property market, which is a store of wealth for the Chinese citizens. And, ultimately, if we started to see more concern there, I think there would be policy that would come to be more supportive of the consumers.

Who gets hurt in this situation? I think it's the foreign and domestic investors that are exposed to Evergrande debt and equity and maybe some other property developers along the way. I think there will be risk there. But the actual citizens and users of this property and homeowners will likely not receive as much of the impact here.

The other expectation is that we'll likely see more easing as a result. We'll probably see that triple R cut we've been waiting for, and we'll likely see some more targeted fiscal response out of China to kind of navigate through this more volatile time period. When we look at the Chinese equity market, it is a market that we're overall underweight, but we're still exposed to.

And when we look at the opportunities there, it continues to be in select industries like technology and environmental beneficiaries and even some of the consumer-branded products in healthcare. Those are some of our companies that we have larger positions on that continue to kind of navigate and do well for this period and in many instances have the policy support behind them from the Chinese government and aren't facing as many of these regulatory or domestic issues.

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