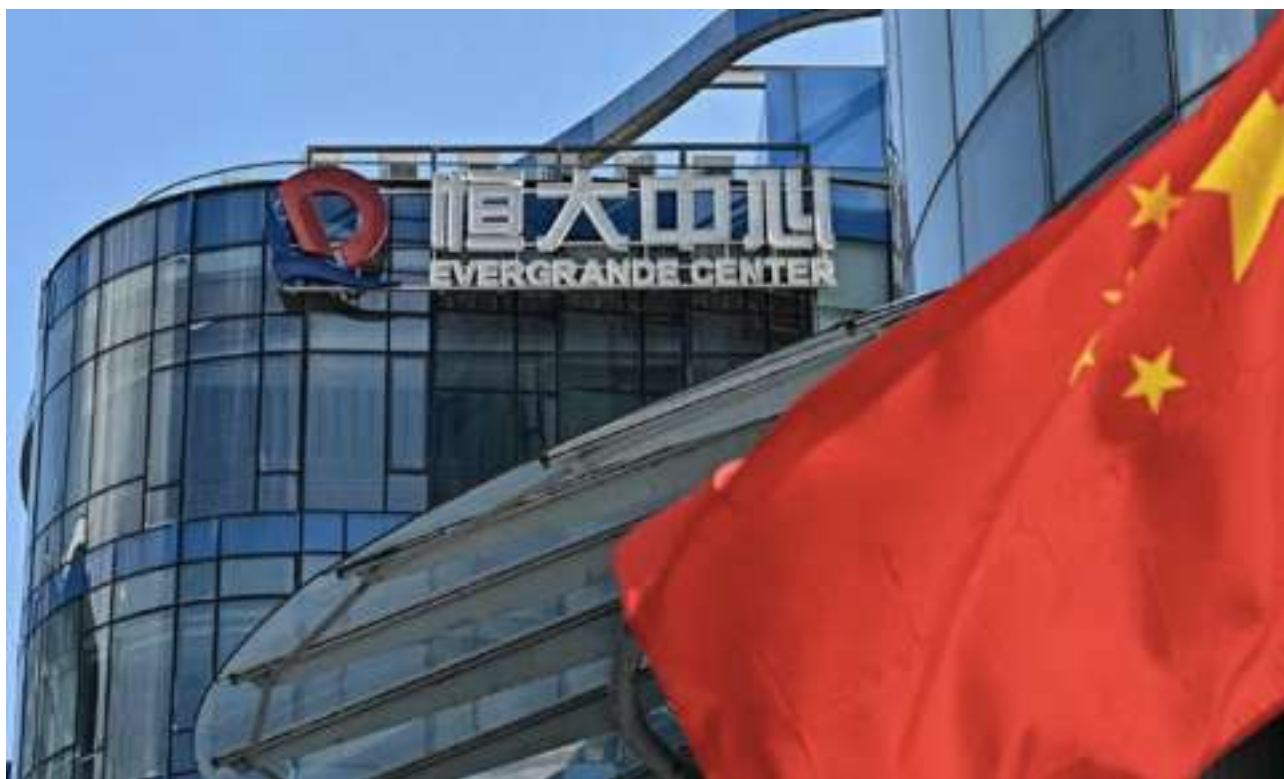


Evergrande

China's Property Woes are Coming Home to Roost



As many readers know, I have spent about half of the last 25 years in China - Beijing and Shanghai, specifically.

One of the things that always struck me in both cities, was the unfathomable property market. Sat in a Shanghai taxi, in the darkness of late evening, marvelling at huge property developments, some 40 storeys high, and with only half a dozen lights on in total. It defied logic as much as small apartments in Beijing selling for more than 40 times average annual income.

So now onto the main topicB - You might have noticed that markets seemed just a bit edgy over the last week or so. It seems they are, at last, waking up to China's property sector, and specifically what's going on with Chinese property developer Evergrande.

With some US\$305billion of debt, and several Dollar bond coupon payments (about US\$6.5million) not paid last week, it is fair to say it has been a long time in the making, but the company could have reached the end of the line.

Why the Evergrande situation is likely to come to a head this week



Evergrande has been described as the equivalent of Lehman Brothers back in 2007.

It is a big, heavily-indebted company, whose debt has seeped into many areas of the economy.

The debt is obviously tied to property markets and house prices, which have been falling since the beginning of 2021 as Beijing has tried to reduce property speculation. But of course, when you consider the wide swathe of materials suppliers, workforce, the 170 + lending banks, as well as those estimated 1.5million buyers who have already paid deposits for properties they are yet to own, there is a real possibility of catastrophe in the making.



It does not end there. Evergrande is also involved in wealth management, electric cars and food and drink manufacturing. It even owns one of country's biggest football teams, Guangzhou FC, so any effects are likely to be felt in the general Chinese economy.

You could surmise that if China just let Evergrande go bankrupt then we'd have a similar situation to what happened in 2008 in the USA.

The obvious response is that 2008 wrote the strategy book for these sorts of crises;- governments and central banks should step in and bail everyone out. That eventually happened after 2008. It eventually happened after the eurozone crisis. It happened during the Covid pandemic, and the assumption has been that it will happen for Evergrande.

However, while the government in Beijing may be planning behind the scenes, with contingency plans, a grand bailout plan hasn't been presented in public yet, markets are now becoming wary.

One problem with these things is that it's much better to step in before a run gets going. The Federal Reserve's actions in 2020, at the height of the pandemic panic in markets, show that the US central bank has taken that lesson to heart. At the first sniff of credit markets shutting down, the Fed just decided to underwrite the entire market, and not just in the US.



The problems with Evergrande are starting to creep into the rest of the Chinese property sector, because people are waking up and realising that this is about more than Evergrande. Lots of companies build and sell houses, and in China, houses just aren't selling these days.

So why does it seem likely that a solution will come this week? Well, the Chinese National Day holidays are 1st to 7th October (the market is shut from Friday to Wednesday) making this a good week for the authorities to step in and to make their move, whilst domestic markets are unable to react quickly.

Evergrande has a 30 day 'grace period' before the missed coupons are considered 'in default', so some sign of the Chinese government erecting a ring-fence to prevent more widespread contagion might calm the nerves.



A recent Bloomberg newsletter suggests that Evergrande is more likely to be an LTCM moment rather than a Lehman one. This is referring to the US bail-out of giant hedge fund Long-Term Capital Management in the late 1990s, rather than letting it collapse like Lehman Bros.

This is probably the most likely outcome. However, people could be overestimating the power of the Chinese government. It's worth remembering that one key reason we favour capitalism and free markets over communism and central planning is because the former is more efficient than the latter.

This is not about politics, it is just logic. If one small committee tries to guess what 1.4billion people are likely to need for the coming five years and plans supply and

demand accordingly, you're going to get a worse outcome than if those 1.4 billion people can just interact freely to adjust supply and demand as they go along.

Centralised planning means that Beijing has a lot of competing and conflicting priorities, and there's a lot of complexity to handle. Lots of things could go wrong, so don't rule out something more like a Lehman Brothers moment just yet.

But what does it mean for you as an investor?

Don't go selling everything.

There is little point in making big changes to your portfolio over this. If you have a clear view of your own asset allocation; you have a clear long-term investment plan (ie how much do you need, what for, and by when?); and you are up to date with these things, you should not be trying to second-guess the Chinese government.



With all that said, there are only two main ways this can go.

One is that China, through overconfidence, recklessness or excess communist enthusiasm, simply steps back and lets the cards fall as they will.

That would terrify everyone!

However, if you're living and investing largely outside of China and its sphere of influence (which most of us are) then even if China's authorities don't step in, our own are likely to do so if there is a serious risk of contagion outside China.

Moreover, if China does step in with a convincing bailout package, then there's every chance that investors will decide a line has been drawn under this crisis. In the longer run, a slowdown in the Chinese economy is something that global markets will have to contend with anyway.

The current headlines about Evergrande might be scary but if you have a plan you are happy with, there is no reason to change it. You certainly should not flog everything and jump to 100% cash - That is almost never a good idea.