FLASH COMMENTARY

September 24, 2021

Demystifying China Headlines

Financial media headlines were replete with coverage of the impending default of Chinese real estate developer, Evergrande, earlier this week. Ordinarily an individual credit event like Evergrande's does not rise to the level we deem relevant enough to warrant a flash memo to clients on the subject. With that said, we have received inquiries on the topic, and felt some narrative may be of interest.

Evergrande is a 25-year old property developer headquartered in Shenzhen, China. It currently has about 800 projects underway in 200 cities, in every Chinese province. **Evergrande's liabilities totaled $304 billion as of the end of June**, comprised of $88 billion in interest-bearing debt as well as large sums owed to suppliers and contractors. The company has sold non-core assets to raise cash. It sold parts of an electric vehicle business, as well as an internet business this summer. Evergrande has presold more than 1.4 million apartments valued at $200 billion that it has yet to complete. The company faced **an interest payment that was due on Thursday, Sept. 23rd in the amount of $83.5 million on dollar-denominated bonds with a face value of just over $2 billion. It is believed that payment was missed;** although the company has a 30-day grace period before bondholders can technically claim a default has occurred.

China's housing policies have struggled to maintain a semblance of order and balance for many years. Prices have steadily risen ever since the real estate market was liberalized in the 1990's. As prices have risen, so have debt burdens and the fear of an impending collapse. An oft-repeated slogan of Chinese officials has been: **"Homes are for living in, not for speculation."** The coronavirus pandemic caused a dramatic hit to Chinese imports, as well as domestic spending. The government looked to property investment as a means of offsetting some of that difficulty. By late summer of last year, officials were beginning to worry that the real estate sector had appreciated too much in a relatively short period of time. Policies were introduced to facilitate a cooling down of the perceived excesses, with a particular focus on borrowing by developers. Debt levels had to be reduced before developers were able to pursue additional borrowing from financial institutions.

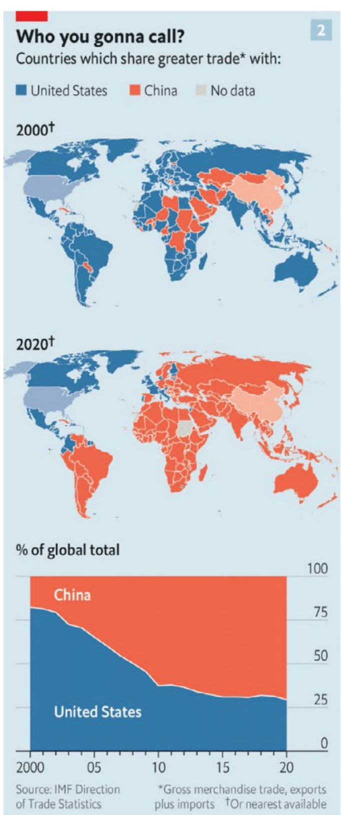
Chinese Real Estate speculation has reached rather lofty levels and a correction has been long overdue. China lacks western-style suburbs. Most Chinese live in urban apartments or condominiums. An investment manager with a focus on Chinese equities recently noted that **the average New York city apartment is priced at roughly 25x the average resident's income, in China, it is 40x**. The news surrounding Evergrande this week appears to be a crisis that will not be "wasted" by the country's leaders – the event will be used to formulate warnings regarding excessive borrowing and speculation. Government officials have been directed to assemble teams of accountants and legal experts to assess the local impact of Evergrande's operations in their respective regions. It's very likely that other developers and government entities will take over unfinished Evergrande projects in order to steer them to completion. Law enforcement teams are monitoring public sentiment and seeking to thwart widespread protests. It's clear that a "soft-landing" is in everyone's interest where property values are allowed to gradually deflate. In the context of the current real estate backdrop, contagion will be avoided in order to protect the broader economy. Evergrande's suppliers and customers may take a haircut but allowing a housing crisis to unfold is highly unlikely. Onshore investors may be bailed out, but it's conceivable that offshore investors may bear the brunt of the fallout. As noted in the table below from Bank Credit Analyst, U.S. financial institutions generally have minimal exposure to China and Hong Kong, since it's a relatively closed economy. Citigroup has a commercial banking business in Hong Kong with direct cross-border exposure that amounts to about 1% of its asset base.

CROSS-BORDER EXPOSURES ($ BILLION)					
	LENDING/ DEPOSITS	TRADING/ INVESTING	OTHER	TOTAL EXPOSURE	AS SHARE OF ASSETS
JPM	9.7	9.9	1.6	21.2	0.6%
JPM-Hong Kong	3.7	1.9	0.6	6.2	0.2%
BAC-China	10.2	2.0	1.3	13.4	0.5%
BAC-Hong Kong	4.9	1.1	0.5	6.5	0.2%
C-China	14.8	5.9	1.1	21.8	1.0%
C-Hong Kong	38.7	9.2	1.1	49.0	2.2%
WFC-China	2.8	0.2	0.4	3.4	0.2%
WFC-Hong Kong	0.9	0.0	0.0	0.9	0.0%
GS*				17.9	1.5%
MS	1.4	2.0	0.6	3.9	0.4%

SOURCE: COMPANY REPORTS, BCA CALCULATIONS.
* GS REPORTED ITS CROSS-BORDER OUTSTANDINGS, A MORE EXPANSIVE CATEGORY THAN CROSS-BORDER EXPOSURES. ON THAT BASIS, JPM AND MS REPORTED TOTAL EXPOSURES OF 1.1% AND 1.3%, RESPECTIVELY.

Evergrande's likely demise will serve as a poignant reminder to the Chinese of the social ills of speculation and a few scapegoats will likely experience pain but since **40% of the typical Chinese person's wealth is in the form of real estate**, the government has every incentive to encourage stability in the housing sector.

We thought it might be beneficial to take a step back and contextualize recent events against the backdrop of China's longer-term strategic plans, to understand the thought process and rationale driving recent developments in China and the implications for Emerging Markets investors, more generally.



The Economist

China's ascendancy on the global stage is rooted in its history. Prior to the West's advancement during the industrial revolution, China was the single largest economy in the world. As President Xi commented during the 100th anniversary of the Chinese Communist Party, this July:

"China is a great nation … after the Opium War of 1840, however, … the country endured intense humiliation … national rejuvenation has been the greatest dream of the Chinese people and the Chinese nation."

China's GDP as a percentage of the U.S.' has increased from around 10% in the 1990's to almost 90%, currently. It is likely that China's GDP will surpass that of the U.S. under President Xi. In 2017 President Xi indicated that **China's progress in recent years has been "… unbalanced and inadequate [for] the people's ever-growing needs for a better life …".**

In 2022 there will be some dramatic political events unfolding in China. Its 20th National Party Congress that convenes every 5 years will assemble in October. Currently, 5 of the 7 most powerful figures of the Politburo's Standing Committee are due to retire, as stipulated by current age-based retirement rules that specify age 68 as a mandatory retirement age. This is a significant event and will impact China's political, social, economic, and foreign policies for years to come. It is thought **that many of the changes unfolding in China currently are preparing the way for that event.**

Much of China's explosive growth in recent years has been concentrated in the internet and e-commerce industries. This has created **dramatic income inequality in China.** According to Forbes', China ranked #2 in 2020 in terms of countries with the most billionaires. The U.S. had 614 billionaires on the list, China had 389. Policymakers in China presumed that a select few of its citizens would become rich well in advance of most of the population, but it is striving to change that as a disproportionate few are viewed as having become too powerful in recent years. With a rising middle class, the demand for a higher quality of growth that benefits a greater swath of the population is rising.

China's leadership is seeking to embrace a balance between innovation and sustainability, globalization and national security, growth and financial stability, all while promoting common prosperity. Note that common prosperity does not mean the same thing as equal prosperity. The intent is to create a social order that benefits the majority of the population in roughly like manner. According to the World Bank, **GDP per capita has risen dramatically in China from $959 in 2000 to $10,500 in 2020.** With a 10-fold increase, the tastes, desires and aspirations of the populace have changed markedly. Thus, a pervading framework has emerged in China that emphasizes achieving the "Chinese Dream" of benefiting society while increasing domestic security and combatting excessive wealth.

China faces a demographic timebomb. Its population is aging rapidly. In 2020, new births dropped to 12 million, or 47% of the peak in 1987. Some forecasts suggest that if current trends continue, new births could drop to 7 million by 2030 and 5 million by 2040. One of the factors that drives GDP growth is the growth of a country's workforce. **Policymakers are seeking to eliminate forces that hinder its citizens' decision of whether to have more children.** As an example, the Chinese educational system places a heavy weight on several exams taken over the course of a child's educational career. Chinese parents spend a disproportionate amount of their income on tutoring services to provide their children the best prospects for career/social advancement. Recent regulatory reforms have essentially banned for-profit tutoring of core school subjects including math, science, and history, as well as tutoring on weekends and holidays. The country is making online tutoring free, all part of the strategy to reduce stress, lessen inequality and induce families to have more children and reverse the falling birth rate.

The trade wars initiated during President Trump's administration was a wakeup call for China. President Xi is being very assertive in reducing China's reliance upon imports. As a result, specific industries of strategic importance are being prioritized to advance technology development and secure supply chain reliability and achieve greater self-sufficiency. Growth and advancements in the following areas will be emphasized in the years ahead:

- **Health Care** – Making health care accessible, affordable and of high quality;
- **Clean Technology** – Pledging carbon neutrality by 2060 via electric vehicles and renewable energy;
- **Communication** – Becoming a global leader in 5-G communication and artificial intelligence;
- **FinTech** – Encourage investing and consumer lending while preserving the stability of the system.

All of the above leads us to the following lesson learned: China's political and social structures are dramatically different than the West's. Sometimes we forget that. Unlike most western nations where checks and balances exist in most institutions and dictate a specific flow and rhythm to most public and private decision-making, Chinese rulers can institute dramatic changes literally over-night. As is the case with all emerging market economies, **it is critical to appreciate the political and regulatory landscape in China, particularly when investment dollars are involved.**

It is not our intent to comment here about the relative merits of investing in China or refraining from doing so. That is outside the scope of this document, but we are certainly prepared to have more detailed conversations with clients on the topic. Suffice it to say that, as is always the case, the risks of any/all investments in a portfolio must be well-understood and assessed on an ongoing basis. As recent events in China have illustrated, investing in a country where legal, political, and economic institutions function dramatically different than the United States or other western nations poses both unique profit potential as well as unique risk characteristics. At Opal Wealth Advisors, we strive to do our best at clarifying and communicating the most relevant and salient dimensions of both risk and return when structuring client portfolios.

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