Evergrande 101: Take a breath

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What can we overreact to today? Guess we know the answer to that one. We entered the weekend with investors looking ahead to this week's Fed meeting and policy decision on Wednesday, plus a full slate of other central bank meetings. On Monday, markets called an audible and all we're talking about now is Evergrande. A lot of that talk has led to 2008 comparisons attempting to decipher whether we are on the verge of a Lehman event and global macro contagion. That got out of hand quickly, so let's take a moment to take a breath and give this a hard look.

Let's get this out of the way up front: This is not Lehman. This is not the end of the world. This is not something we need to run and take cover from. But what is really going on?

Let's start with the basics: What is Evergrande?

China Evergrande is China's second largest property developer which sells apartments mostly to upper and middle-income buyers. Over the years, however, it's evolved into much more of a conglomerate with operations in a wide swath of sectors from autos and healthcare to media and finance. The reason it's now dominating headlines is that it is the most indebted property developer in the world, with over $300 billion in outstanding liabilities, and there are concerns about the company's ability to make payments on upcoming loans and bonds.

Is this all new news?

Contrary to the reaction in global markets on Monday, the news around Evergrande did not just emerge over the weekend. Markets have known about the company's struggles for months and that's been reflected in its share price, which has been pretty much a straight line down since March 2021. Bond investors certainly weren't suddenly caught off guard either, as the 2022 8.25% bond with a coupon coming due this Thursday 9/23 has plummeted from essentially par at the end of May to 24 cents on the dollar as of Monday. The 2025 paper even traded through 50 as early as July. Default has been priced in for months. And the news flow has been just as dire, from investigations to summons, contractors halting construction, and loan prepayment demands.

So why now?

With the laundry list of negative headlines over the past few months it's clear that investors have been aware of the looming risks. So why did global markets suddenly wake up and start caring about Evergrande? We'll never really know for sure, but perhaps it's simply a case of a belated overreaction. Markets don't care until they do, and then they overreact. We've steadily heard the street become more and more cautious over the past few weeks as one by one strategists have updated their views expecting a pullback. Sentiment has flipped decidedly neutral with retail investors in particular moving to their most bearish levels since September 2020. With a soft sentiment backdrop and investors looking for excuses to sell and protect profits, it could simply be a case of selling begets selling, particularly into light liquidity with many Asian markets closed for holiday.

What's the financial risk?

Let's consider what's at stake with Evergrande's looming default. The big number everyone is citing is Evergrande's total liabilities of RMB 2 trillion. That's about $300 billion, which certainly isn't small, but let's put that into perspective. Of that total, only a small amount is financial securities. How small? Direct borrowing is worth RMB 573 billion. That's just $88 billion, which accounts for 0.08% of sector loans and just 0.04% of all onshore bonds. Not systemic risk by any means. Those financial liabilities are simply too small and too widely spread across global investors to pose a systemic threat on a global scale. Contagion certainly gets clicks, but the conditions are just not there for a sweeping contagion event.

What's the real risk?

So financial liabilities are relatively small, but what about the rest of the remaining liabilities? This is the avenue of risk that really matters. Of the RMB 2 trillion that everyone is panicking over, about half is tied up in trade payables and acceptance bills – basically loans extended by suppliers or contractors. For example, if Evergrande builds some housing units, they might finance the construction materials with suppliers for the next 12 months. This is where the dominoes could begin to fall if the Chinese Communist Party (CCP) lets this unravel. Those trade payables are tied to over 8,000 upstream and downstream partners. Defaulting would distress these trade partners. Think of all the projects that would be put on hold. Those jobs are in over 220 cities and would result in undelivered contract sales to nearly 2 million home buyers. Quite a few upset Chinese citizens.

What's the one thing that the CCP is deathly afraid of? Being overthrown. How does one get overthrown? Social unrest. How do you get social unrest? Tell 8,000 partners that they aren't getting paid. Tell 2 million people that they aren't getting the homes that they put down payments on. Tell the estimated 70,000 people that bought Wealth Management Products tied to Evergrande trust loans ($42 billion) that their investment is worthless. The bottom line: An outright bankruptcy of Evergrande would lead to widespread social unrest. This is where the contagion lies. Not in the financial system, but in the social fabric channel.

So is this a Lehman moment?

No. Full stop. The property sector's linkages to the financial system are not on the same scale as a large investment bank. China is, to a large extent, a command-and-control economy. In an extreme scenario, even if capital markets were shut to all Chinese property firms, regulators could direct banks to lend to such firms, keeping them afloat and providing time for an extended "work out" if needed. A lenders' strike in a strategically important part of the economy like real estate – simply put – would be a policy mistake. The CCP would have to let it happen, and if they want a mess, they can let it happen. If they want a controlled default, they can orchestrate that too.

The lesson from Lehman: Moral hazard needs to take a back seat to systemic risk. We are already hearing about social unrest and protests. Employees are protesting that they haven't been paid. Trust product buyers are protesting that they want their money back. Suppliers are protesting because they haven't been paid. This is the contagion route that the CCP cannot afford to see spread. Expect the CCP to flood liquidity into the system to make sure that the contagion remains muted. And restructuring will likely see homebuyers and workers getting paid at the expense of equity. One way or another social unrest must be contained.

Is this enough for a Lehman moment? Nope, not even close. Contagion comes via banks and no systemically important US banks are materially exposed. A slowdown in Chinese GDP growth has little bleed through to US growth, because 70% of US growth is driven by domestic consumption. The US buys goods from China, but the US relies very little on exports to China. Europe, on the other hand, may feel a modest hit as China continues to deleverage and shift away from its dependence on the real estate sector. This will mean less fixed asset investment and fewer imports from the EU. But these will be second order impacts that would likely occur even without an Evergrande default as China continues to restructure its economy.

Bottom line: Evergrande is the sacrificial lamb. Set the example and let them feel the pain, all the while keeping the risks ring-fenced. Message delivered: Mind your leverage and mind your debt. Banks are in control and circumventing the system will not be tolerated.

Does this change our outlook?

Despite all the dire headlines and still uncertain outcomes, it's hard to say this materially changes the outlook moving forward. The Wall of Worry grows taller day by day, sentiment and positioning is neutral to bearish, the Covid front appears to be improving, and all of those growth catalysts remain intact: robust consumer, strong corporate balance sheets, inventory restocking, and an emerging capex cycle. Investors have been recycling narratives and looking for an excuse to sell, yet markets have remained remarkably resilient and that outlook persists. A healthy consumer plus corporations flush with cash plus a dovish Fed plus easy financial conditions equals a perfect recipe for strong growth and risk on. Evergrande doesn't change that.

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