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Investment Talks:
Evergrande and its spill-over effects: ongoing adjustments, but inflection point may be close


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- ***Evergrande crisis**: Despite Evergrande paid the coupon due on September 23, just one day before the 30-day grace period deadline, the company's crisis is still unresolved. But it appears to be idiosyncratic and not systemic, as the market impact has been primarily on China's HY bond index with limited spill-over into the broad EM HY space. Yet, the situation clearly points to the weakness of the overall property sector in China, with other developers recently having trouble: Fantasia Holdings Group and Sinic Holdings Group have been downgraded to selective default by S&P. Overall, we don't expect to see a messy outcome for Evergrande, owing to policy intervention that is likely to kick in to avoid excessive economic pain from the crisis.*

- ***Implications for real estate sector**: Activity in the housing sector is cooling fast as tighter restrictions on the property market have squeezed financing to the sector and seen construction activity decline. Deleveraging the housing sector and stabilising housing prices are priorities for China's long-term political agenda, but given the relevance of the sector (accounting for 25-30% of China's GDP), an orderly de-leveraging is key. We believe that the government will continue to focus on managing systemic risks, minimising spill-over effects by ensuring social stability and protecting homebuyers. Clearer guidance from the PBoC and increasing coordination between central and local governments should bring some stability to the sector.*

- ***Economic outlook**: The housing slowdown is only one of the drags on Chinese real GDP growth in Q3. We recently downgraded our projections for China's GDP from 8.3% to 7.7% in 2021 and from 4.9% to 4.7% in 2022. The growth and policy dynamics year-to-date suggest Beijing is not averse to higher volatility in growth figures to make necessary social changes. However, in the long run, growth of 4-5% is still achievable. The focus for Chinese authorities will be long-term sustainability at the expense of short-term stability.*

- ***Investment implications**: Overall, we believe investors will have to deal with high volatility not only regarding macroeconomic figures but also in Chinese financial assets (in particular, equity, credit). This is necessary medicine in the short term that should support the stabilisation of Chinese assets and reinforce the structural outlook in the medium term.*

Evergrande crisis: limited spill-over to the broad EM high yield market

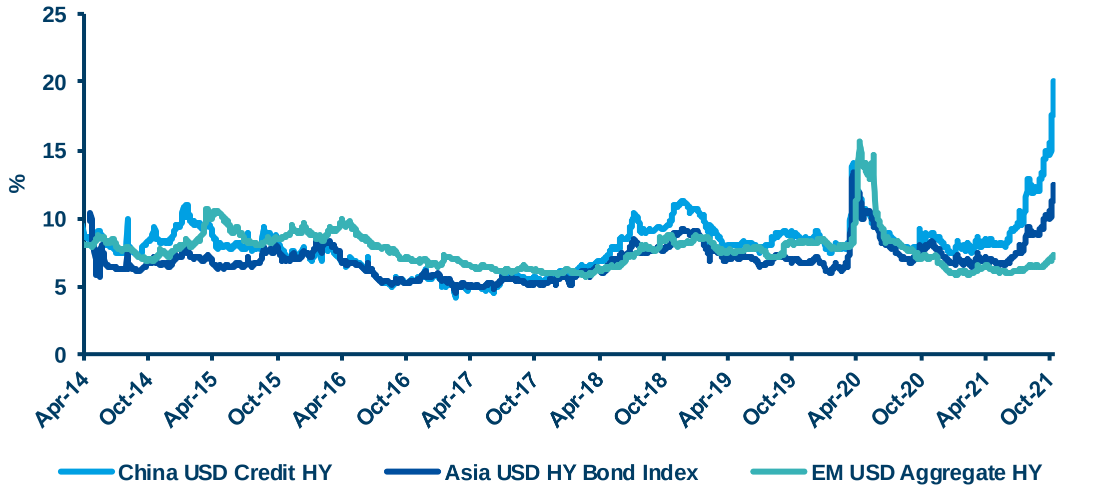
Despite the last-minute payment of the pending USD bond coupon that allowed the company to avert bond default, China's Evergrande Group crisis remains unresolved. The company continues to deal with its liquidity crisis, although during the grace period (one month after the first missed payment), it was able to pay the coupon for two RMB bonds, on 23 September and 19 October. The developer company is still facing interest payments on four USD bonds in 2021, and in the coming year it will have a $7.4bn of maturing onshore and offshore bonds to deal with.

While Evergrande is still under deep scrutiny, **global investors are focused on the possible spill-over of this idiosyncratic story.**

"The overall impact on EM HY market has been quite contained, signalling the idiosyncratic nature of Evergrande story."

Liquidity and a credit crunch are affecting other developers, increasing the number of selective defaults and troubles for China's property companies. In particular, there has been significant news flow on Fantasia and Sinic Holding. The former failed to repay $206m on 4 October and the latter is in a distressed debt situation. Both have been downgraded to selective default by S&P (the grace period for a non-payment of coupon is 30 consecutive days).
The yield on China's HY bond index in US dollars (in which property firms account for more than 50%) skyrocketed to 20%, reaching 10-year highs .The weakness of the Chinese market has also affected Asian HY markets, which are now yielding close to 2020 highs. But, **the overall impact on EM HY markets has been quite contained, signalling the idiosyncratic nature of this shock, the overall improving fundamentals, and the low sensitivity of this segment to US interest rates.**

China, Asia and EM HY bond yields (US$)



Source: Amundi, Bloomberg. Data as of 18 October 2021. Bloomberg Asia Ex-Japan USD Credit China High Yield, Bloomberg Asia USD High Yield Bond Index and Bloomberg EM USD Aggregate High Yield.

"We do not expect to see a disorderly outcome for Evergrande, thanks to policy intervention".

Recent developments in the real estate sector in China are a choice on the part of the authorities to bring down leverage and reduce medium-term threats to financial instability. Following the recent market turmoil, policy adjustment is under way.

People's Bank of China (PBoC) commented last Friday (15 October) on Evergrande's debt crisis, pointing out that risks to **the financial system stemming from the developer's struggles are controllable and unlikely to spread**. Furthermore, Vice Premier Liu He shed more light on Wednesday that overall risk is controllable in the real estate sector with a few problematic cases, and reasonable funding needs are being met. On the Evergrande case specifically, the company and the government have hired specialists in debt restructuring procedures to find possible solutions.

We believe that the policy is at its inflection point and valuations should be attractive in certain credits after the price correction.

Property sector consolidation will continue, with policy in place to stabilise it

The real estate sector is a key pillar of the Chinese economy – it accounts for 25-30% of GDP, including upstream/downstream sectors. The sector accounts for almost 50% of fiscal revenue for local government, with the majority of public spending coming from within China. Finally, it is a store of wealth for average Chinese people: mortgages account around a third of total loan book for banks. **So, our view is that this sector is systemically important for the stability of the country and economy.**
China's property sector has been in consolidation mode since the introduction of the three Red Line policies in 2020. Key policy objectives were to reduce financial leverage and prevent the market itself from overheating. However, the operating environment for real estate companies was already difficult based on a confluence of factors:

- Slowdown of overall economy;
- Margin pressures triggered by cost inflation and weaker selling prices;
- Funding pressures for developers;
- Rising mortgage costs for consumers; and
- A restrictive policy stance.

Deterioration in fundamentals of China's real estate market accelerated recently. For the period from early August to the first week of October, the volume of land transactions fell by more than 40% versus the same time last year, with land auction withdrawal rates climbing across the country and property sales volumes falling by 15-20%. On top of the fundamental factors noted above, distressed situations among property developers negatively affected consumer confidence.

"Clearer guidance from the PBoC and increasing coordination between central and local governments should bring some stability to the sector".

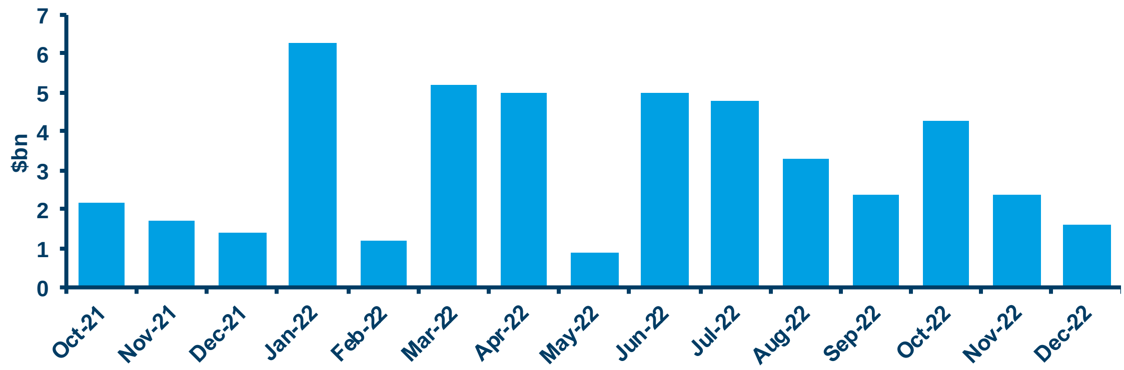
Marginal changes in policies are under way. Last Friday, the PBoC urged banks to stop withdrawing credit lines from developers and to correct their over-execution of macro-prudential policies. Delayed loan disbursement to developers and prolonged mortgage approvals are likely to ease. Meanwhile, more local governments joined the camp calling for a loosening of housing purchase policies, mostly in cities where prices are falling.

We believe that the government will continue to focus on managing systemic risk, minimising the spill-over effects by ensuring the social stability and protecting homebuyers. Weak developers may have to restructure their obligations, but business owners are required to address their debt obligations in accordance with the rule of law.

Valuations of China high yield property bonds reflect fundamental pressures, with c.50% trading at least at a 20% discount to nominal value. **The market is also worried about the maturity wall** in January 2022 when $6.3bn of bonds come due, which will be followed by $5bn maturing in both March and April.

However, **clearer guidance from the PBoC and increasing coordination between central and local governments should bring some stability to the sector.**

Chinese real estate HY bonds maturing by month



Source: Amundi, on Bloomberg and Goldman Sachs. Data as of 15 October 2021.

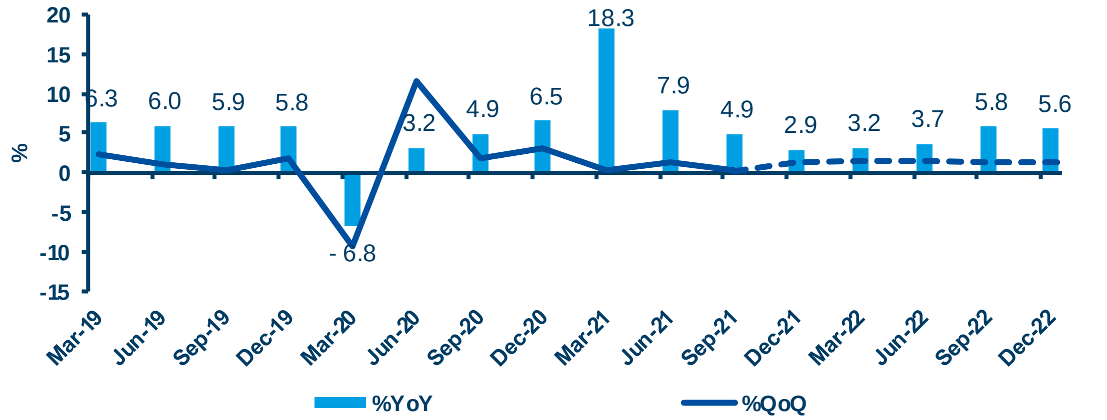
“Investors should reset their expectations on China GDP growth: 8% annual growth is a thing of the past. Expect much lower figures and less policy reaction to them, with a focus on long-term stability”.

Expect lower GDP growth for China in 2022

The housing slowdown is only one of the drags on Chinese real GDP growth in Q3. Despite the relaxation of social distancing rules, a confluence of factors continues to weigh on the economic recovery, including the NDRC's[1] energy use control, which proved to be a supply constraint and weighed on industrial production, along with higher production costs and a cooling construction sector. This week's release showed a deceleration of GDP from 7.9% YoY in Q2 to 4.9% in Q3 (+0.2% QoQ) which drove an overall **downward revision of China's growth outlook for 2021 and 2022. We now expect China's GDP to grow 7.7% and 4.7% in 2021 and 2022, respectively, down from 8.3% and 4.9% a month ago**.

Due to the high base last year, headline annual growth should decline to around 3% YoY in Q4 and stay below 4% in H1 2022. In Q1 2022, we expect to see a production comeback as global supply constraints ease and energy use quotas renew. We still expect some adjustment to the zero tolerance policy for easier domestic travel in early 2022, which should become less of a drag on the service sector. Service consumption and infrastructure investments are likely to bounce back, leading to a rise in activity.

China GDP growth forecasts



Source: Amundi Research. Data is as of 18 October 2021.

However, beyond recent releases, **what is important to note is that markets are awakening to a new policy reaction function:** the growth and policy dynamics year-to-date suggest Beijing is not too concerned about higher volatility in growth figures in order to make necessary social changes.

Going forward, we are likely to see a muted policy response following record-low growth figures. Investors should acknowledge that we have entered a new era, with less buoyant growth. The focus for Chinese authorities will be long-term sustainability at the expenses of short-term stability.

Near term, the odds of broad monetary easing have declined: an additional 50bp blanket RRR cut in October looks less likely, and we expect no policy rate cut. A targeted relending programme for carbon neutrality projects or SMEs[2] at preferential rates looks more likely (ie, targeted rate cuts). Some intervention is expected on the fiscal side. Meanwhile, fiscal policy has turned more supportive. The issuance of government bonds has gathered pace, supporting a rebound of public spending.

Overall, we believe that investors will have to deal with high volatility not only regarding macroeconomic figures but also in Chinese financial assets (in particular, equity and credit). This is necessary medicine in the short term which should support a stabilisation and reinforce the structural outlook for Chinese assets in the medium term.

1 The National Development and Reform Commission is in charge of China's macroeconomic planning.
2 Small and medium enterprises.

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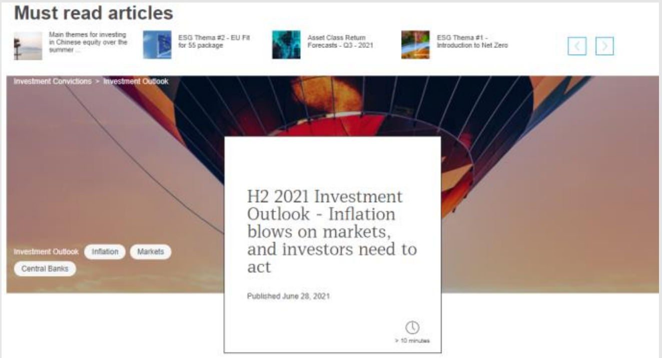

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