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Worse than Lehman

Evan Lorenz writes:

Internet searches for "Lehman Brothers" skyrocketed in the weeks leading up to Sept. 23, when China Evergrande Group, Inc. skipped a bond payment. Would Asia's largest junk-bond issuer punch out a 2008-size hole in China's overleveraged economy? Perhaps worse, we speculate below. The hole could pierce the world economy.

As every schoolboy knows, Evergrande is China's second largest real estate developer by sales. It builds rows and rows of amenity-enhanced residential towers—and otherwise occupies itself with electric vehicles, theme parks, insurance, movie theaters, internet services and what have you.

Grant's has long identified Evergrande as the face on the milk carton of China's debt-fueled, fixed-asset investment bubbles (see the issue dated June 2, 2017). As of June 30, Evergrande showed Rmb 1,966.5 billion ($304 billion) of balance-sheet liabilities. Owing to a decline in profitability, the ratio of net debt to Ebitda has climbed to a towering 16.7 times as of June 30, from 7.2 times at year-end 2019, according to CreditSights. The aforementioned unpaid interest tab—$83.5 million on the dollar-denominated 8¼s of March 2022—will give way to outright default if uncured within 30 days.

Outsize on their face, Evergrande's liabilities look like a rounding error next to China's $52 trillion banking system, a sum equal to 56% of estimated 2021 world GDP. For reference, U.S. banking assets sum to $22.8 trillion and Japan's to $11.8 trillion.

So, is Evergrande the Chinese equivalent of Lehman Brothers? No, but there's sparse comfort in that fact. First, however, the similarities: While Evergrande and Dick Fuld's ill-fated bank stood out for their aggressive behavior, neither was the direct cause of their respective crises. China's financial system has been on a slow boil since the May 24, 2019 failure of Baoshang Bank Co. Ltd., the first mainland bank default since 1998 (*Grant's*, July 24, 2020). And president-for-life Xi Jinping tightened the screws on the property sector last year by preventing developers from expanding liabilities if they don't pass a three-part balance-sheet test, which, of course, Evergrande failed.

Lehman's bankruptcy ravaged many Lehman counterparties, but the remote cause of that Sept. 15, 2008 filing was the July 2006 pop of the U.S. housing bubble. Between the pop and the filing, HSBC Holdings plc admitted to subprime losses (February 2007), a pair of Bear Stearns Cos., Inc. credit funds hit the rocks (June 2007) and U.S. GDP peaked (December 2007).

If Evergrande did file for court protection from its creditors, it would be unlikely to set off a similar chain reaction in China's financial system. Measured as a percentage of the banking resources of their respective countries, Evergrande's liabilities foot to 0.6%; Lehman's—as of its last filing as a public company—summed to 4.8%. Mainland banks, as compared with their American peers 13 years ago, have greater leeway in marking their losses to market, so don't expect to see the equivalent of the Primary Reserve Fund's breaking the buck on the day that Evergrande cries uncle.

"The concern here is not interbank funding," Logan Wright, who leads Rhodium Group's research on China, tells me. "It's really a concern about growth." Real estate construction and related output generates an estimated 29% of Chinese GDP. According to Liberum analyst Tom Price, China's property sector alone accounts for 20% of global steel and copper consumption and 9% of aluminum demand.

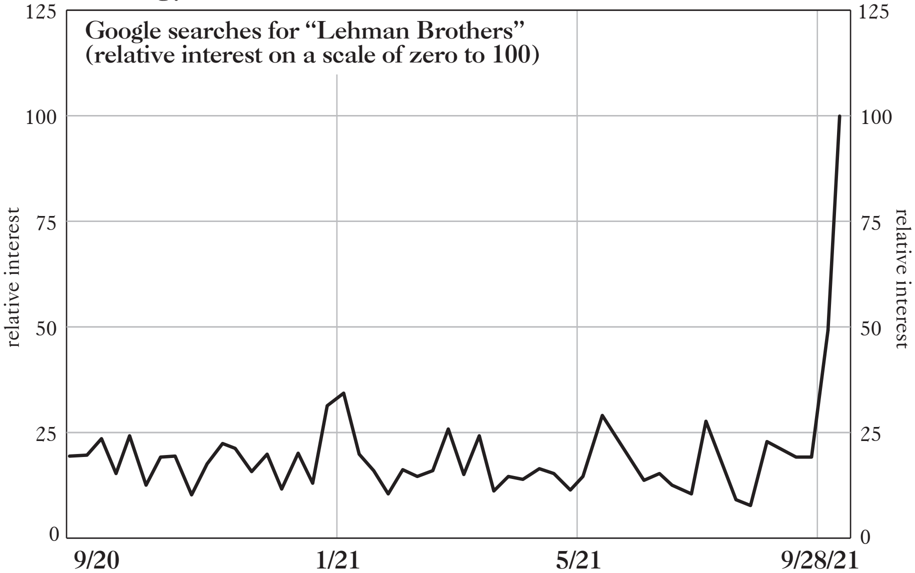
"The expansion in household debt since the end of 2015 is a $6.4 trillion flow and still counting," says Wright. "It's still growing at a pace of about a trillion dollars per year, and most of that is mortgages." In the 12 months ended June 30, Americans added $610 billion to mortgage balances despite the fastest growth in house prices on record. Housing accounts for 78% of Chinese consumers' net worth vs. just 35% in the United States.

Customer deposits on presold apartments represent upwards of 11% of Evergrande's liabilities. It's for this reason that the attempts by some Chinese cities to seize such deposits to force the timely completion of unfinished Evergrade buildings has had such a damaging effect on the developer's liquidity.

Unpaid suppliers, S&P Global Ratings noted on Sept. 20, "have filed lawsuits against Evergrande and have managed to freeze assets," leading to "substantial halts in project construction." Some of these jilted investors, unpaid vendors and apartment-less buyers are skipping the courts to protest outside Evergrande offices across the country.

It's all weighing on market sentiment and on the funding costs for developers not named Evergrande. Real estate sales fell by 16% year over year in the first half

Analogy of the month



source: Google Trends

of September across 52 large cities, following a 20% drop in August. Stuck with unsold units, developers purchased 90% less land from local governments in the first 12 days of September than they did in the same period last year. As local governments owe $8.4 trillion in debt and earn around one-third of their revenue from land sales, a real estate slowdown could easily mutate into a local government and state-owned enterprise crisis.

China's housing market, moreover, is overbuilt and expensive. A 2017 survey by Chengdu's Southwestern University of Finance and Economics found that 22% of the housing stock was vacant. The U.S. Census Bureau estimates that 11% of American houses and apartments were empty as of June 30. Poring over the public data, Rhodium finds that developers are sitting on 30 million unsold units. For a proxy of underlying household formation, 8.13 million couples married last year.

"The price-to-income ratios in Beijing, Shanghai and Shenzhen exceed a multiple of 40, compared to 22 in London and 12 in New York," Harvard economics professor Kenneth Rogoff recently noted on VoxEU. The Urban Reform Institute, which publishes an annual report on anglophone housing costs, defines "unaffordable" as a multiple in excess of three.

Thanks to low birth rates, China's working-age population (i.e., citizens between the ages of 15 and 64) peaked in 2015, and the total population is expected to begin declining by 2030, according to the World Bank. All in all, China needs to taper construction activity and tackle nosebleed prices. (Since 2016, Xi has been saying that houses are "for living in, not for speculation," but speculative manias have minds of their own.) Because the problem is bigger than Evergrande, no mere cleanup of that train wreck would put China in the clear.

Xi's consolidation of power also complicates matters. After crackdowns on corrupt party officials, think tanks, capitalists and the property sector, the autocrat-for-life may find that he has also cracked down on some indispensable sources of intelligence. It's one thing to run an economy without real interest rates (the American experiment now in progress). It's another to run it without information, or, at least, without reliable, non-Party-approved information.

Xi's self-coronation also alters the political calculus of a bailout. Investors have long believed that the government would intervene to make them whole if the all-important housing market ran aground. But that imagined "put" was underwritten, in part, by political term limits. No administration wanted to be responsible for the collapse in China's housing market, so officials were always willing to reinflate the bubble one more time and stick the problem to their successors. "Previous leaders only needed to care about the current cycle, but Xi's government is concerned about the volatility across multiple cycles," Wright briefed his clients last month. "As a result, any measures to extend the property bubble in time will create risks on Xi's watch. In many ways, bursting the bubble now, while extremely painful, will be much easier than five years from now, when demographic headwinds will be much more apparent."

A slowdown in construction would come at a bad time for China's economy. The mainland consumer was already flagging before Evergrande's latest mess. August retail sales expanded 2.5% year over year in August, against expectations of 7% and down from the 8.5% recorded in July. An electricity crisis is ripping through China, with rolling blackouts in northern provinces over the weekend. Beijing itself is on the blackout agenda in the days ahead. To limit the demand for power, authorities are asking companies to cut production, residential users to limit their operation of air conditioners and elevator patrons to take the stairs (so far, for trips shorter than three flights).

A housing correction could weigh on GDP for quite some time. "Every country that has achieved 'miracle' growth under the high-savings/high-investment model—of which the USSR and Japan are just the most famous—has later shifted into a phase in which growth is driven mainly by surging debt and the systemic creation of bezzle," Michael Pettis, a professor of finance at Peking University, tweeted on Monday. "And in every case the country faced a very difficult economic adjustment during which subsequent growth fell below even the most pessimistic predictions. The longer it took to adjust or the more extreme the typical imbalances, the more difficult the adjustment tended to be."

Sitting in our lower Manhattan observatory, we make no claim to the knowledge that a handicapper would need to assign the probabilities between, on the one hand, an outright real estate bust and, on the other, a managed decline. But, because we do know that China is the biggest buyer of many of the world's commodities, we reason that a deceleration of Chinese growth would weigh on miners like BHP Group Ltd.; China-oriented banks such as HSBC Holdings plc and Standard Chartered plc; major raw-materials-exporting nations like Australia and Brazil; and on bulk shippers, including the *Grant's* picks-to-click Eagle Bulk Shipping, Inc. and Genco Shipping & Trading Ltd.

Since about four-fifths of Chinese household net worth is tied up in housing, a real estate bust, in combination with Xi's push for "common prosperity," would likewise punish luxury brands. As one proxy for its consumption of the kind of baubles that fill the pages of the *Financial Times*'s glossy "How to Spend It" weekend supplement, China accounted for 26% of Swiss watches sold by value in the first eight months of 2021.

"I think that China starts to export deflation into the world," Anne Stevenson-Yang, the co-founder of J Capital Research, tells me. "The demand for iron ore is going to decline. The demand for coking coal, for copper, and, of course, for luxury goods. You will see car sales decline. Eventually you will see the equity values of U.S.-listed companies that have big businesses in China—whether that is A.O. Smith or GM or whatever, all of those things—start to decline."

So, no, Evergrande is no Lehman. In the worldwide context, it could be worse.

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