WHAT DOES PRESIDENT XI THINK?

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The crisis in the Chinese real estate market is not solely about the real estate company China Evergrande. The key to understanding China Evergrande's fate and the consequences for the company's customers, creditors and shareholders is to understand President Xi's agenda. For many years, there has been an implicit social contract between the Chinese people and the Communist Party, where the Communist Party ensured progress and high growth in return for the loyalty of the people. As China has grown, it has become necessary to renew the social contract as a result of difficulties in sustaining the high growth trajectory. Xi has therefore rewritten the premise with a lower economic growth outlook, but with a higher quality of growth (e.g. with a focus on the environment) and greater equality in society.

In other words, the Chinese Communist Party, led by President Xi, has expelled the Western-inspired capitalistic path. The new direction is "Common Prosperity Capitalism", i.e. a more socialistic approach, where capitalism benefits all stakeholders. Maybe Xi took the decision seeing angry Americans storming Congress in early 2021. No matter what, the fact is, that China has changed direction since then.

President Xi's main goal is to ensure social stability in China to maintain the support of the people. Therefore, we are seeing measures to ensure a more even distribution of wealth, ensure low prices and improved living conditions for Chinese families – this also in light of the government's concern about the country's declining birth rates. The political focus is now redirecting support to the domestic sectors that make everyday life better and cheaper for the Chinese people.

Over the summer of 2021, we saw actions related to companies that have achieved extraordinarily high profits at the expense of the general population. This has affected companies in the internet, education and healthcare sectors, where share prices have declined markedly. Costs for healthcare and education are two major expenditures for the Chinese middle class.

The third major expense is housing, where home ownership is typically also the most important asset for households. Over the past year, the Chinese government has tried to cool the real estate market, e.g. by implementing a general tightening of the credit markets. This is also in a context where corporate indebtedness in China has reached record levels. Thus, in August 2020, China introduced three strict credit and liquidity requirements ("Three red lines") for the real estate sector, which the sector must comply with by no later than 2023. The objective is to enforce lower leverage in the real estate sector. As a result, home sales have stalled hurting highly indebted property developers like China Evergrande. It was probably never the intention to bring property developers on the brink of bankruptcy, although companies like China Evergrande never managed to adapt to the new rules and market conditions.

President Xi and the Communist Party have no interest in a collapse of the housing market, quite the contrary. Ideally, they want stable house prices and less speculation. This is key to understanding the scenarios around China Evergrande.

Social stability is the key

At present, we do not know the future of China Evergrande, which is the second largest real estate developer in China. The company's liabilities correspond to approx. 2% of China's GDP, and the share price has fallen more than 85% this year. A bankruptcy is quite likely, and shareholders have more-or-less already been wiped out. Here it is important to understand that Xi's concern is not - what can be perceived as - the more speculative shareholders.

The recent developments have parallels to the US investment bank Lehman Brothers in 2008. President Xi does not want to be supportive of 'moral hazard', in line with the new political direction "Common Prosperity Capitalism". 'Moral hazard' was also one of the reasons why the US in the end did not offer support to Lehman Brothers. However, the ensuing social consequences of an uncontrolled meltdown of China Evergrande is unacceptable for Xi, as this will have serious consequences for the credit and housing market. Therefore, we are convinced of a political rescue package, where shareholders will suffer huge losses and creditors must accept a significant write-down, while the almost 2 million homebuyers, who have prepaid installments to China Evergrande will be rescued.

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The bankruptcy of Lehman Brothers caused a freezing of the interbank market as financial institutions suddenly feared the counterparty risk. The current challenge in China is that real estate financing is at risk of freezing. Thus, the problem is not the banking sector per se. China Evergrande's total debt is just 0.6% of the assets in the banking sector, while the total debt for all developers is obviously larger. An important difference compared to Western countries is that the Chinese state controls the big banks. It provides far greater opportunities to support and secure liquidity and long-term financing opportunities for the real estate sector in the wake of a bankruptcy of China Evergrande.

President Xi's key focus is the interest of the population. Therefore, he will do whatever it takes to support the housing market. The Communist Party has both the motive and tools to ensure long-term stability. However, it is a risk whether the government can execute in a timely manner, although we take comfort in China's previous experience in handling similar cleanups with precedents such as Anbang Insurance and later China Huarong Asset Mgmt. Both companies had outstanding debt in the billions.

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International contagion

The possible effects of contagion can be divided into three categories: 1) the direct economic effects, 2) the direct financial effects, and 3) indirect portfolio effects. Regarding the economic effects, a possible weakening of the Renminbi may cause a negative spillover weakening the competitiveness of other Asian countries. Regarding financial risks, a potential solution where domestic creditors are offered better terms compared to the international creditors could have a negative effect on international capital flows to China and the other emerging market countries. The indirect portfolio effects are more complicated, but could occur, if portfolio investors decide to lower portfolio risk by selling other related assets. We will get more insights in to the potential contagion in the coming weeks, as we see a discrimination between domestic and foreign creditors as the biggest risk.

New investment themes in China

We have no direct exposures to China Evergrande, although our Asian strategy has approx. 2% exposure to other property developers, where the share prices have been negatively affected and therefore fallen in sympathy. Our Emerging Markets strategy has not had any exposure.

So far this year, the Asian equity markets have performed significantly worse than the US and Europe, but we believe that the secular investment themes in Asia remain intact. Moreover, China's new policy direction changes our investment focus towards companies in domestic sectors, where strategy and business models are aligned with President Xi's objective of "Common Prosperity Capitalism".

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