May You Live In Interesting Times

If you've checked in on the financial press in recent weeks, you've surely heard the name "Evergrande" mentioned. This month's market commentary will focus on the ongoing Evergrande saga: what it is, how it happened, what it means, what it *doesn't* mean, and how it impacts our client portfolios.

WHAT IS EVERGRANDE?

China Evergrande Group has been one of China's largest property developers, with subsidiaries involved in a variety of different businesses including mineral water, pig farming, electric vehicles, amusement parks and a professional soccer team. At its peak, the company employed over 150,000 workers and invested billions into new development each year.

HOW HAS THIS HAPPENED?

China has been experiencing a dizzying real estate boom for years. Government policies have encouraged this boom up until late last year. In China, cities have limited power to tax residents and companies; one way cities can raise funds is to sell land to developers. These taxes can total roughly a third of tax revenue in some areas. Also, many Chinese citizens looked to these new real estate developments as investment vehicles under the belief that values would rise no matter what under the watchful eye of government leaders in Beijing.

The result of this boom is a mammoth supply of vacant units, buildings, and even entire cities. There are enough vacant units to house an estimated 90 million people - or the entire population of Germany. Also, entire "ghost cities" built to resemble Paris, Venice, and Jackson Hole sit empty.

Alongside this national boom, Evergrande has experienced exponential debt-fueled growth over the years, having borrowed over $300 billion from investors, banks, and even customers – many of whom pre-bought homes months (or even years) before they were built. These customer deposits often served to fund company operations, setting up a dynamic similar to a Ponzi scheme. As long as Evergrande was able to pre-sell its new developments, the company's cash flows would remain strong. If new development stopped, the company's cash flows would take a significant cut.

Late last year the Chinese government, in an attempt to control the bursting of the real estate bubble, enacted a "three red lines" policy that effectively tried to clean up property developers' balance sheets. Part of this policy was to limit the amount of new debt these companies could issue to fund new development. And without new development, Evergrande's fortunes have taken a massive hit.

WHAT DOES THIS MEAN?

In China, Evergrande's troubles could have a ripple effect across the economy. First and foremost, the company had to stop work on unfinished projects so now property buyers might not have anywhere to live. Suppliers and contractors aren't able to be paid – it has been reported that Evergrande is offering unfinished units to pay off some of these debts.

Chinese investors and banks may get hit with losses, though the final amount is unknown. The company is in the process of selling off some assets in order to raise funds in the near term.

More broadly, Chinese economic growth is being threatened as the reins are pulled in on the real estate sector. For years, the phenomenal growth of the Chinese economy was fueled by investment into the real estate sector; as a percentage of overall economic activity, real estate accounted for nearly a third. But as the years passed, the Chinese have been experiencing diminishing returns on these investments. Between 2008 and 2019, total debt within the Chinese economy rose from 169% of gross domestic product to 306% of GDP, while GDP growth fell from 10% per year to 6%. From 2000 to 2010, productivity growth was over 2.5%; since 2015, it has been negative.

Complicating things further is the Chinese government's recent push to expand state control over the economy. In recent months, regulators have moved in on tech companies involved in online payments, videogames, ride-sharing and education. These are the most visible efforts in a campaign by President Xi Jinping to rein in market forces, direct the flow of capital and restrict how companies and investors make profits. Large companies are being coerced into making large "charitable contributions" to Beijing's preferred causes, sell shares to state investment funds and put state officials on their boards.

The phrase "may you live in interesting times" has been widely attributed to an old Chinese curse. "Better to be a dog in times of tranquility than a human in times of chaos" wrote Feng Menglong in *Stories to Awaken the World* (published in 1627!). For the Chinese economy, these are interesting times indeed.

WHAT THIS *DOES NOT* MEAN

When news of Evergrande's troubles were first reported, the phrase "Lehman moment" was used a lot. Of course, a "Lehman moment" refers to the Financial Crisis in 2007 and 2008, where the collapse of Lehman Brothers triggered massive losses across the global financial system. Given Evergrande's size and prominence in the world's second-largest economy, the initial concerns were understandable.

However, we believe that the potential for Lehman-esque losses and chaos is extremely unlikely. The company has already taken steps to shed non-core assets to raise money, and the Chinese government has been stepping in to provide some liquidity for the country's financial system. Foreign exposure to Evergrande is limited; the largest US banks (JP Morgan, Bank of America, etc.) have less than 2% of their balance sheets exposed to China as a whole, let alone Evergrande itself.

So while there will certainly be negative impacts felt within China, these should stop at the Great Wall.

HOW WILL THIS IMPACT CLIENT PORTFOLIOS?

Our investment philosophy's commitment to diversification means that we will maintain exposure to emerging markets, of which China does play a role. Within our most balanced asset allocation, total exposure to China is limited to around 2%-3% of the overall portfolio. Even in light of the Evergrande issue, we believe that maintaining some exposure to China is prudent given that a) the country is still growing at one of the fastest clips in the world, and b) it remains the world's second-largest economy.

More broadly, what we own reflects our belief that the macroeconomic picture is one of rising growth, rising interest rates and rising inflation. This "reflationary" environment has historically benefitted cyclical "value" stocks which should lead the market higher from here, though with the potential for some volatility along the way. In preparation, we recently trimmed our overweight allocations to riskier areas of the market in order to manage total portfolio volatility. Overall though, our client portfolios maintain their cyclical orientation.

Within equities, we previously increased our clients' exposure to larger, more developed international markets. We've also made moves to increase exposure to smaller companies in the US and have added targeted exposure to more cyclical areas of the US large cap space. The recent rise in interest rates has caused these areas of the market to outperform on a relative basis over the near term. This just reinforces our position that cyclical "value" stocks should benefit more than expensive "growth" stocks.

In the fixed income area, we remain focused on more credit-sensitive securities (with less exposure to the more cyclical areas of the market) with shorter maturities as a hedge against potentially rising interest rates. Within the alternative market segments, we have increased our exposure to "real assets" (think commodities and real estate) as a hedge against the potential for higher inflation. We have maintained our exposure to the diversified alternative sector as a hedge against potential market volatility.

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