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Amundi ASSET MANAGEMENT

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China in the spotlight: what markets should look at

INVESTMENT TALKS

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- **Evergrande: not a systemic risk, but a wake-up call in an over-indebted world.** Over the past days, financial markets have been shaken by the Evergrande saga – China's second-largest property developer – which is facing difficulties in servicing its huge debt pile. The scale of such a potentially large restructuring event is weighing on Asian credit markets, with bonds of other companies in the property sector (an important part of the high yield (HY) segment) trading down. **Putting this event into the broader context**, the **contagion effect on global markets has been limited so far**, with some volatility in equities (the VIX index hit an intraday high of 28.8 on 20 September 2021) and a modest retracement from historical highs (the S&P 500 is down 2%). Most likely, Evergrande will need to restructure its debt stock (another interest payment was due on 23 September; failure to fulfil this obligation within 30 days may trigger a formal default).
- **The Chinese authorities have proven their commitment to avoid a meltdown** (i.e., the People's Bank of China (PBoC) has injected a net 460bn renminbi, $71bn, of short-term cash into the banking system in the past five working days) and the government might intervene in the restructuring process, preventing Evergrande from defaulting in a disorderly way. However, they have also signalled clearly to the market the will to **stop real estate speculation and the need to deleverage the sector.** This process is going to be choppy. In a capital-intensive sector such as real estate, a decline in debt levels will be reflected by a strong volume reduction. Therefore, we expect the sector to be under pressure in the short term, although the deleveraging process should be beneficial over the medium term.
- **Evergrande is a wake-up call for investors and a reminder of the highly leveraged sectors** in the system, with valuations at boiling point. **Down the road, we are likely to see cracks in relation to leverage issues coming to the surface, which will require additional focus on credit selection across the board.**
- **Implications on growth are material:** The housing slowdown is one of the negative drivers behind the downgrade of our China GDP forecast. Activity in the sector is cooling fast and liquidity pressure will remain high with no policy changes. More generally, **China's activity data has broadly surprised on the downside in Q3, with exports being the only exception**. Policy tightening, self-imposed restraints (zero tolerance Covid-19 policy, de-carbonisation, production cuts, electricity rationing) and the global chip shortage have contributed to the slowdown. We no longer expect growth to recover to trend in Q4 2021. **We foresee average 2021 real GDP growth to be 8.3%, down from 8.7% previously, and 2022 growth to be 4.9% against 5.4% previously.** What is still hard to quantify is the consumer outlook, given that demand is suppressed and de-leveraging is ongoing. China's slowdown in relation to its main trading partners should be monitored carefully.
- **Broader investment implications**: **We expect higher volatility in global markets in the coming months and not only from China**. Other sources of uncertainty include the ongoing negotiations regarding the US debt ceiling and skyrocketing energy prices in Europe. **All these things are happening just when financial markets are tight in terms of valuations. Therefore, we believe that it is time to be neutral in terms of risk allocation and increase scrutiny on those areas which could be hit by spillover effects** (e.g., Asian high-yield bonds, construction-linked commodity prices). In general, although risk perception on China remains high in the short term, **we remain constructive on Chinese assets over the long term for structural reasons** (the rebalancing of growth towards domestic demand, a step-up in strategic sectors, the internationalisation of the renminbi and its global influence).

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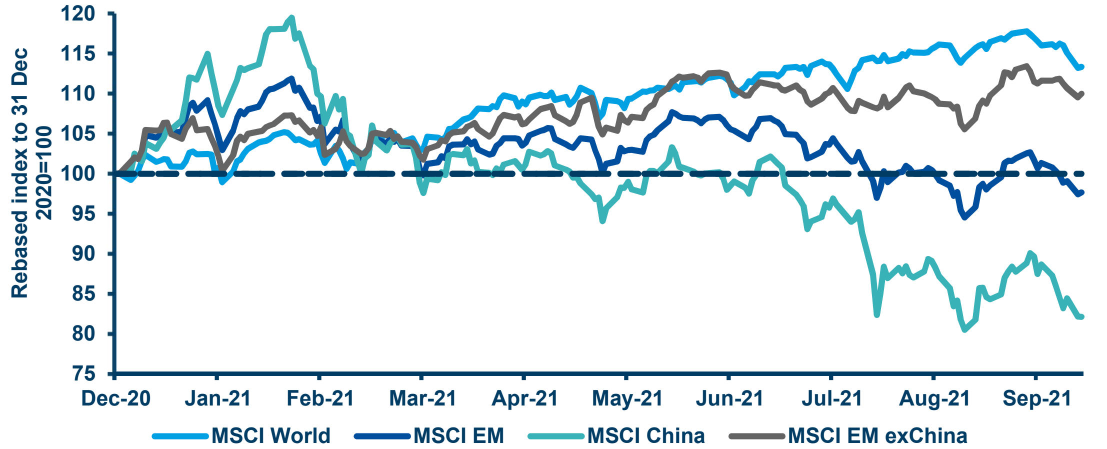
"We believe that China's government might intervene in the restructuring process and not allow Evergrande to go into a disorderly default."

Evergrande: not a systemic risk, but an area of attention

Over the past weeks, financial markets have been shaken by the Evergrande saga – China's second-largest property developer – which is facing difficulties in servicing its huge debt pile (it needs to repay some $7.4bn of bonds maturing in 2022). This has hit global financial markets, with equity valuations down and higher volatility (the VIX index hit an intraday high of 28.8 on 20 September 2021).

YTD equity market performance



Source: Amundi, Bloomberg. Data is as of 22 September 2021.

The scale of such a potentially large restructuring event is weighing on Asian credit markets, with the bonds of other companies in the property sector trading down, while the banking system's exposure to the real estate sector has declined – loans to the property sector have fallen from 37% in 2016 to 26% in 2021 – limiting the fallout on the former.

At the time of writing (24 September 2021), the situation appears to have calmed down somewhat, as Evergrande settled interest payments on a domestic bond on 22 September. However, another payment worth $83.5mn was due on 23 September on its five-year dollar bond; failure to fulfil this obligation within 30 days may trigger a formal default. At the same time, the PBoC injected cash into the banking system, soothing fears of imminent contagion from the property developer. In any case, these developments confirm what the market has been anticipating for some time: **Evergrande will need to restructure its debt stock**. The Chinese authorities have proven their commitment to financial de-risking. They have ceased the tightening trend and we believe that they are closely monitoring the situation and may ultimately **take supportive action to ensure market stability and prevent any systemic risk.**

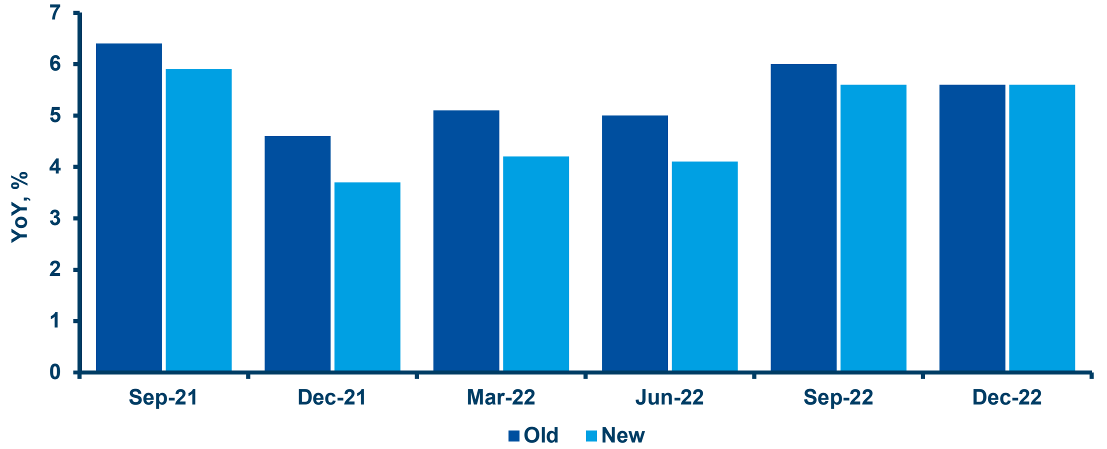
The case of Evergrande illustrates that Beijing will continue its financial de-risking policy and reduce housing sector leverage. The scale of loss that investors will face seems uncertain. However, the repricing has been happening for some time, giving markets an opportunity to adjust. As such, we believe that contagion can be contained and that the Chinese government has proven itself adept at taking such action to preserve stability in its markets. We believe that the government might intervene in the restructuring process and not allow Evergrande to default in a disorderly manner. The company is preparing a reorganisation plan and using the time to sell its none-core assets.

"We now expect average 2021 real GDP growth to be 8.3%, down from 8.7% previously, and 2022 growth to be 4.9% against 5.4% previously."

Fallout for the China growth outlook

Growth wise, **the housing slowdown is one of the negative drivers behind our GDP growth downgrade for China**. Activity in the sector is cooling fast and liquidity pressure will remain high for the sector with no policy changes. More generally, activity data has broadly surprised on the downside in Q3, with exports being the only exception. Policy tightening, self-imposed restraints (e.g., zero tolerance Covid-19 policy, de-carbonisation) and the global chip shortage have contributed to the slowdown. **We have downgraded our growth forecasts** and no longer expect sequential growth to recover to trend in Q4 2021, due to the housing slowdown and the de-carbonisation production cuts**. We now expect average 2021 real GDP growth to be 8.3%, down from 8.7% previously, and 2022 growth to be 4.9% against 5.4% previously.**

China GDP growth forecasts



Source: Amundi Research. Data is as of 22 September 2021.

We expect production to rebound in Q1 2022, as global supply constraints ease and energy use quotas renew. We also expect some adjustment to the zero-tolerance policy for easier domestic travel in early 2022, which should become less of a drag on the services sector. Also, we expect credit growth to bottom out and stabilise in Q4. Credit conditions will become looser. Finally, the PBoC will support growth by keeping loose interbank liquidity and may cut the reserve requirement ratio (RRR) further in October.

Investment implications

"We believe that contagion to the broader market should be limited even though there might be some volatility in the coming months."

We believe that contagion to the broader market should be limited even though there might be some volatility in the coming months. We believe that the Evergrande situation is not a systemic risk for financial markets. However, financial markets are tight, warranting high scrutiny by investors, especially on those segments that may be hit by spillover effects, such as EM high-yield bonds and Asian ones in particular – the real estate sector accounts for around 50% of the BofA index. We see lower-rated issuers (especially single-B) as being mostly impacted by the liquidity squeeze and events linked to Evergrande. The funding squeeze, uncertainty about asset sales and the growth slowdown in the physical market may trigger some defaults in the sector, but we do not expect any top-tier developers to fail at this stage.

Evergrande is not the only issue facing global financial markets nowadays (e.g., the US debt ceiling, energy prices in Europe and geopolitical developments), **so we believe investors should remain neutral in terms of risk exposure during this phase.** In addition, China is facing other macroeconomic challenges in the near term and this is an incentive for the government to ensure an orderly resolution to this disruptive event. Since the Chinese government is demanding financial responsibility from its companies, there should be a positive impact on sustainability in China's credit markets over the longer term. In general, although the risk perception on China is currently high, **we remain constructive on Chinese assets for structural reasons** (the rebalancing of growth towards domestic demand, a step up in strategic sectors, the internationalisation of renminbi and its global influence).

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Definitions

- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.
- **VIX:** VIX is the CBOE volatility index. The VIX index is a measure of market expectations of near-term volatility on the S&P 500 (US equity).

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