THE National Investor

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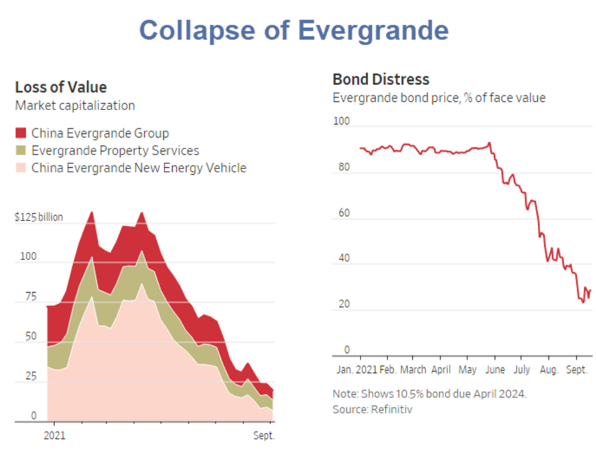
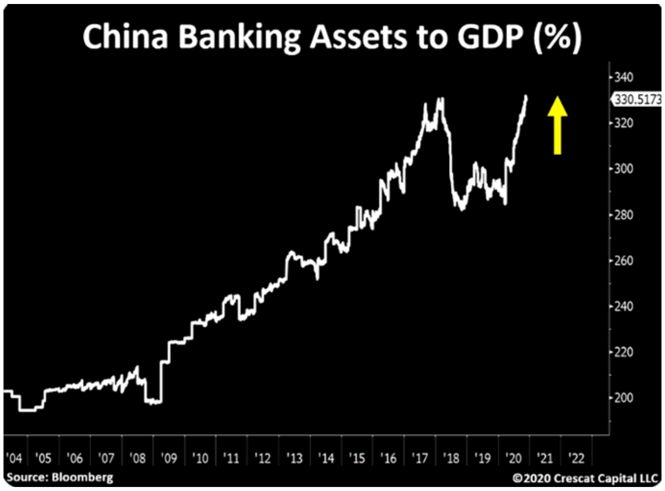
THE EVERGRANDE MESS: DID CHINA GO TOO FAR?

Yours truly—and others—have mused for *years* about the possibility (inevitability?) of **an epic bust in China**. Yes, that nation (*still* ignorantly called "communist" regularly, though its command-and-control apparatus is more akin to the national socialist economies of the 1920s-1930's, though with *far* greater room for private profit) has had an advantage *in that very design*. Time and again, essentially by decree, China has been able to kick various cans down the road; even though at times that has meant making use of "controlled implosions" I have discussed from time to time as authorities attempt to rein in the worst excesses *a little*.

In Evergrande, however—the most indebted real estate developer *on the planet*—China may well have allowed a single debt monster to grow too large to be dealt with as easily. As I am finishing up this issue as we embark on the last week of September, one coupon payment ($83.5 million) due on part of its staggering $300 billion-plus debt load has not been made, triggering a 30-day grace period ahead of a *formal* default. Evergrande has provided no input to investors on this; nor on another looming interest payment due this week on another chunk. *Thus, what looms is the potential of the largest-ever bond default on U.S. dollar-denominated paper in Asia.*

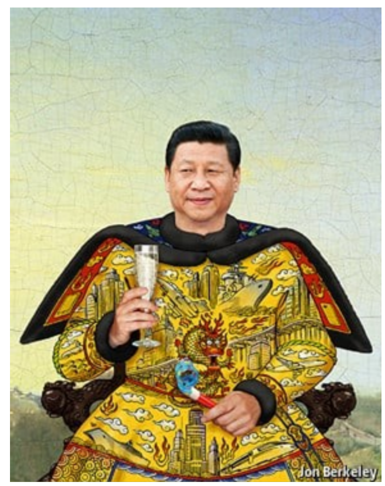


For all the ignorant talk about "communist" China, it needs first and foremost to be acknowledged that **China has become the rising power it has due to the use *and abuse* of credit/fractional reserve banking outdoing even anything the U.S. has engaged in**. Its bloated banking—and shadow banking—system has enabled an incredible spurt of growth for about a decade and a half



now that (among other things) led to major surges in commodity prices in the "aughts" (about 2002-2008) and then somewhat of a renewed, albeit on and off one, since. China's GDP soared…as did its footprint the world over, especially in places like Africa where Chinese interests have descended with ever more paper in hand as they try to commandeer unspoken-for resources.

What's especially interesting about the timing of *this* larger debt crisis for China is it comes at a time when President Xi Jinping has been shifting his priorities in ways that are decidedly *contrary* to this continuation of unbridled debt-fueled capitalism. Pretty much a modern-day *emperor* now in all but name, Xi has already been roiling Asian markets for months (though with merely a few ripples in our part of the world so far) with one move after another: cracking down on various industries/sectors, limiting accessibility globally to some markets and most recently with his crypto currency crackdown.



Having first built modern China into an economic and military force to be reckoned with *on unprecedented mountains of debt*, Xi now has taken on the task of trying to digest/manage all this *without ending up like Japan did a generation ago*. Most—I daresay, most of *you*—have long since forgotten the story of *that* "Yellow peril" that was going to conquer the world; among other things, buying real estate, high-profile landmarks and gobs of other American assets through the 1980's especially (AND being a proximate cause of the 1987 U.S. stock market crash, lest you've forgotten *that* too.)

Japan's ride as the big kid on the block globally ended with its rolling bubble-burstings from 1989-1991. To this day, Japan's stock market has yet to recover its all-time peak. The country is now largely ossified, and all but irrelevant globally, as it seeks to paper over its lingering debts and simply (but fairly comfortably) *exist*.

***Far more* is at stake—for China and the world—as China's new emperor attempts to avoid that same fate.** In the *Financial Times* as the weekend was drawing to a close and markets were preparing to take a fresh look at things, Ruchir Sharma ended a meaty chronicling of China's debt monster and seeming no-win situation thus:

> "…Chinese president Xi Jinping is trying to revive a form of socialism reminiscent of the era of Mao Zedong. His government has started cracking down on the excesses of capitalism, including the wealth and power of tech tycoons, and the rampant speculation and rising debts of the property sector.
>
> "The problem: what happens in China no longer stays in China, which is the main engine of global growth*. In many ways, China follows the same deformed model of capitalism as most western countries, only more so, taking on ever increasing levels of debt to generate less and less growth.*

"The result is growing financial fragility. Like its more advanced rivals from the US to Japan, China has created a financial system that is in constant need of government support and stimulus. Policymakers keep economic growth going at any cost, and repeatedly back down from tightening policy at the slightest hint of economic or financial trouble. Whenever a company of any consequence gets into difficulty, authorities have stepped in with a bailout. That's especially true in China, where in recent years default rates have run far below the very low global averages.

"Conditioned to expect the government to intervene in time to stave off any crisis, global investors have not pulled money out of China, yet. But if Xi were to depart from the past, by purging debts and letting defaults spike, it could trigger a nervous breakdown in the world's financial system.

"*What we are likely to witness over the coming months is an epic clash between a leader with supreme powers determined to change the course of his nation, and the economic constraints imposed by gargantuan debts*. For now, the markets are still betting that the stakes are too high, even for a leader as powerful as Xi, to wean China suddenly off a debt-fueled form of capitalism the world has been practicing for years." (*Emphasis* added.)

Last Monday on *CNBC*, Allianz's Mohamed El-Erian importantly pointed out that **Evergrande's unpayable (indeed, now even unserviceable) debts coming to a head did not occur in a vacuum.** Though we still have yet to see any major exodus by global investors (though word has it that some large banks have already started finding ways to extricate themselves from this rat's nest of troubles) it must be remembered, he said, that **Evergrande and its woes are now added to a situation where questions have arisen as to whether China is even "investable" any more by foreigners.** All the recent crackdowns…favoring of local companies and punishing foreign ones…still-shady reporting requirements…and MUCH more have, I am sure, former President Trump on an "I told you so!" binge.

And frankly—though I don't believe this is either his base case or goal—I suspect that President Xi wouldn't be all that upset if Evergrande contagion DID cause a global deflation/market meltdown anew. It would provide "cover" to *really* clean house and clean up bad debts and the worst parts of China's system; and set the stage for a more energetic comeback for his country. (**NOTE**: For a good *reporting* job on this mess, *sans* any editorializing, see https://www.cnbc.com/2021/09/17/china-developer-evergrande-debt-crisis-bond-default-and-investor-risks.html for all the moving parts of this new crisis.)

One of the more interesting—I'll even say somewhat humorous—sidebars to this whole saga is the extent to which key figures of the capitalist "West" have alternately enabled and covered for China as it has constructed this mess. Just as it's not fashionable (yet) in most Gen-X and related investment circles to be anything *but* bullish on Bitcoin and other crypto currencies, among the globe's financial elite nobody has wanted to be anything *but* bullish on the ascendance of China for some time.

A China enabler from "the decadent West""

Among others, this has now blown back on current I.M.F. Managing Director (and clearly *useful idiot* to Emperor Xi) Kristalina Georgieva (left) who—while in leadership at The World Bank—reportedly greased the wheels there to cause that institution to put LOTS of lipstick on China views.

For a good look at this issue—which has led in recent days for calls for Georgieva's resignation—check out https://www.theepochtimes.com/mkt_morningbrief/world-bank-leaders-including-now-imf-chief-pressured-staff-to-boost-chinas-ranking-in-report-investigation-finds_4001726.html from *The Epoch Times*.

AND, notable among the voices calling for this dingbat's head is *The Economist*, one of the elite globalist financial publications: see https://www.reuters.com/business/economist-magazine-calls-georgieva-quit-imf-over-world-bank-data-scandal-2021-09-23/. That tells you just how much rot there is in this "relationship" between China and many of its long-time enablers, coming from a publication that is normally supportive of *both*.

SO, NOW WHAT?

Even Yours truly is still *somewhat* reticent over making more of this than I already am. We don't—indeed, really *can't*—know yet what the outcome of this all will be. The odds favor a papering over of this, even as many take their "hits" on Evergrande; what one commentator has termed a "marketized default" that is *only in its beginning stages*. That term also supposedly is to be found in official government documents as regulators in China try to figure out how to foster MUCH larger "controlled implosions" without bringing everything—*and everyone*—down with them.

In short, the Peoples Bank of China is revealing that it has instructions to save *the system* even as a LOT of blood is let at Evergrande (and hopefully remains contained there in a better fashion than problems in 2007-2008 were "contained" to the U.S. sub-prime mortgage markets.) Significant cash infusions, repo purchases and more have been coming as authorities seek to put a firewall around Evergrande…and keep everything else together and liquid.

In the end, my view is that (and I don't recall what columnist posited this, otherwise I'd give credit where it's due) the "marketized default"—piecemeal, perhaps and also *maybe* not entirely—of Evergrande will more likely resemble the 1998 collapse of the hedge fund Long Term Capital Management; and *not* the 2008 collapse of Lehman Brothers, the latter of which had far more onerous and broad consequences for *all* markets. Not that the milder potential outcome won't hurt, mind you: at the *very* least, you can say good-bye to this mindless, auto-pilot bullish run that most risk assets have been on. **Unintended in this fashion as it was, perhaps, the Evergrande fallout/lessons will do a lot more to reintroduce price discovery and some fundamentals back into markets than the Fed (and other central banks) are of a mind to do otherwise.**

In no particular order of importance, here are some key points/subjects as I am following them:

* **China's overall environment/credit rating.** *See* https://www.reuters.com/business/fitch-says-possible-china-evergrande-default-may-have-broader-effects-2021-09-15/. Provided the dominoes don't fall in *too large* a number/too abruptly, the country's credit rating could stay in tact. This would keep most of the risk of a full-fledged retreat from Chinese markets/assets at a minimum.

* **Involuntary "bail-ins."** While—as always—the usual suspects warn of a (in the present case) Biden Administration plot to confiscate savings, force bail-ins to save the banks, etc. (more on that in the next issue or two when I have room for such things) in the case of Evergrande this is REALITY rather than conspiracy theory. Particularly in the case of any of the management of the real estate developer-turned-

hedge fund of sorts (a la Enron), efforts are being made to have them put money back *into* the company to mitigate damage.

* **Repaying with property.** Much as the *usually not used* provision in the average U.S. mutual fund prospectus, Evergrande in some cases is reportedly paying off investors *in kind*; in this case, with discounted property. See https://www.reuters.com/world/china/evergrande-begins-repaying-investors-with-discounted-properties-bloomberg-news-2021-09-19/. NOT what investors had in mind!

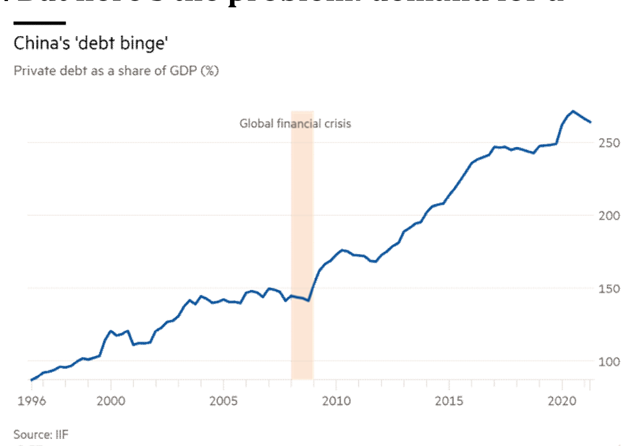
*** Price controls.** Reports are also of regulators instituting draconian (Craig Mellow spoke to this in his September 20 column in *Barron's*) "fixing" of "allowable" real estate prices in some cases, to curtail runaway speculation that has pushed prices artificially high. As part of this whole thing there seems looming a nation-wide reassessment of China's own real estate bubble and this problem it has caused. (And MUCH more so than in America—where Chairman Powell can claim the Fed is all about helping the hoi polloi, while it furthers policies that have made housing unaffordable for many—in China such a crackdown on runaway real estate will be broadly *welcomed*.)

* **Confiscation**. At least two local governments in China have seized sales revenue from Evergrande properties, raised from investors to further the bubbles (and profits for the managers/financers.) This is said to be "to prevent potential misuse of funds." Whatever you think of wisdom, legalities or whatever of what the capitalist-minded "Western" financial press is derisively calling more "communism" in China, this is going to be CHILLING when it comes to *further* real estate investment for quite a while.

* **"Severe" Consequences**. In the U.S., the biggest culprit of the subprime crisis and 2008 debacle—former Fed Chairman Alan Greenspan—did not suffer from his lunacy and mad scientist-like financial alchemy. Ditto any big shots at the major banks. Merely a handful of relatively inconsequential mortgage brokers and assorted other "soldiers" were punished, most all of whom were simply doing what the system encouraged and told them to do until the music stopped.

Heads will be rolling at Evergrande, though; *especially* as it has come out that some executives took their money and ran early. *Here again, if nothing else, the pace of "building" and all that comes with that will slow markedly*, when there are far fewer "developers" sticking their necks out.

* **Exporting a DEFLATIONARY wave?** -- The irony of all the above is that, by and large (and putting aside the fact that things should never have been allowed to progress this far in the first place) what Chinese authorities are doing on all the above is GOOD. **But here's the problem: demand for a LOT of things is going to get hit.** And that's even if the orchestrated and (hopefully) controlled marketized default, in whole or part, of Evergrande, comes off without any *systemic repercussions*.



In one sense, as I alluded to above, this is welcome: price discovery for commodities, valuations, etc. will come back *some*, as they will be *relatively less* dictated by artificial factors such as runaway and unsustainable credit. **Risks to investors near-term are that *some* commodity themes will have a setback**. Ditto the overall notion of an ongoing "reopening" story globally, given that economic activity and demand will be dented by the Evergrande saga and unwinding, and the resulting more sober financial/economic lives in China.

The Doomsday scenario is that China goes the way of Japan and rides *numerous* uncontrollable bubbles back down to Earth…and ignominy. **I.M.O. there will be *war* before that happens, if nothing else as a means to cover for the financial misdeeds here** (another way in which "communist" China will actually practice the strategies of its ostensible "capitalist" adversaries.) For his part the purported China lapdog Joe Biden, lest you missed *this* story also, has just made a more provocative *military* move against China than anything the allegedly reckless Orange Wonder ever thought of, in his recent so-called AUKUS move. So, China has some rhetorical *cause*.

While I *at present* do not necessarily think things will go that far either market-wise or militarily, such is an ever-present *possibility*. In closing, here are a couple *more dire* takes on all this:

* https://charleshughsmith.blogspot.com/2021/09/whats-really-going-on-in-china.html - This from Charles Hugh Smith, suggesting among other things that China *really is* going to jettison some of the excesses of their recent "capitalism." *A sea change in the global economic and geopolitical order of things*.

* https://www.zerohedge.com/markets/chanos-warns-evergrande-crisis-could-be-worse-lehman-china - This, some thoughts from thoughtful China critic and bear, the famed short seller Jim Chanos. He *does* seem to think this has the potential to turn into something *far worse than* Lehman, though with China bearing the brunt of the damage by itself.

Separately just after this issue, I'll e-mail thoughts about our asset allocation priorities.

The above is excerpted from the third issue for September, 2021

Don't forget that those of you so inclined can follow my thoughts, focus and all pretty much *daily* ! ! !

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