Evergrande: Old memories haunt us

We have just learned that the bursting of the real estate bubble that we have been talking about since 2016 has just happened, and it has not been because of a small company, but by that of a Fortune 500 company. The Chinese real estate company has announced that it may not be able to meet the upcoming payments of the gigantic $ 300 billion debt on its balance sheet. Everything seems to indicate that this will not pass on to be one more anecdote in the economics books, but that, after COVID and this, we will not want to see sweet and sour chicken on a menu, nor even a mile away.

by Miguel Ángel Temprano
CEO Orfeo Capital
September 20th, 2021 Reading time: 6:20 min

It has just been exposed that a Chinese company called Evergrande, unknown to almost all Western mortals, is probably going to default on the next maturities of its debt. This data in itself would be insignificant to us, if not because it is not only a company member of the select Fortune 500 club, but because everything looks like it is only the tip of a gigantic iceberg that, although being so far away and in a country as hermetic as China, it is sure to hit us. And unfortunately, it would be the second great blow that, in such a short time and after COVID, comes to us from the Asian country.

"At the end of the first decade of the 21st century, China had a growth model based on exports. Purchases that we paid for with bank debt."

To understand the problem, we must go back to the first years of this century, where the credit facility made us westerners buy a quantity of products in China, using loans from our banks.

China had become, and despite what I am about to tell you, it has remained as what it is: the factory of the world. Thus, China had an exaggeratedly positive trade balance that exceeded 10%. On the contrary, the United States had it in the opposite direction, but also in large numbers, exceeding 6%.

The credit crisis that erupted with the collapse of Lehman Brothers nipped the foreign buying mechanisms with bank financing in the bud, forcing the Chinese government to change its growth model from an export-based model to one based on domestic consumption. Without a doubt a full-blown cycle change.

"By 2014, Chinese private debt was around 100% of GDP. This is the fuse that has lit the current bonfires."

At that time, and this data is very relevant, private debt over GDP in China was 100%, because such relevant figures would be the fuse that would light the current bonfires.

But while Lehman Brothers and the financial crisis left us battered, to the Chinese this came very handy, as we began to create new money to recover as if there was no end.

"The QEs of the 2008 credit crisis encouraged buying Chinese assets at interesting rates, thanks to cheap bank financing."

The quantitative expansions (the QE, which I have already explained in a video on our YouTube channel) of 2011 and 2012 were executed in a way that I usually explain with a DIY example: I want to cover the holes in my garden table so it can endure the winter and I can't do it one by one, so I add a large amount of material to cover it all. But unlike what we should do to the table with the excess material, to withdraw most of the surplus. But with these Quantitative Expansions what was done was to leave the surplus money in the market, which many people who did not need the credit used as a good, pretty and cheap investment weapon.

Many Western investors saw their opportunity: they borrowed money from banks at rates close to zero and invested it in Chinese assets at rates close to 6%, at a time when the exchange rate with the Yuan was stable. The business was perfect for the Chinese. Westerners assumed the risk of their credit while they carried out this transformation of the production model.

Towards 2014 western central banks began to withdraw monetary stimuli, or at least part of them. They started with the famous Tapering, and there the bargain for easy money to buy these assets ended, forcing the Chinese government to be the ones to promote these credit facilities to its citizens.

In addition to creating a new money supply, they did so by lowering the reference interest rates. This, in addition to continuing to allow the country to grow at figures never seen in the West (at least for those of us still alive), that led to the number of private indebtedness going from that of 100% that I mentioned before to 220%. In less than six years, private debt had grown 110%. And that in a communist country.

"That in a communist country its private debt grows 110% in six years, until it becomes something worrying, at least it is funny."

You don't have to be a guru to know that when money is left over and everything is bought, in the end the quality of the assets that are acquired is not as desired, nor is it, almost always, as expected. And in any case the price that has been paid for them is usually excessive, if not abusive. But it is already known that greed is a very common capital sin. And if this is done in exorbitant quantities, what is created are giants with feet of clay, like Evergrande.

The Chinese company Evergrande is a monster in a market so painfully known to us, real estate. It is a company with more than 200,000 direct workers and some 4 million indirect ones. With a portfolio of more than 1,300 projects spread over some 280 Chinese cities, of which it seems that they have dark issues everywhere. That is to say, assets of those that were bought with good, nice and cheap money. Pretty? well I don't know about that but sure neither good nor cheap.

"Evergrande is a Chinese real estate company easily and painfully identifiable to us Westerners."

Also, as it is usually the case, it had "diversified" its business with diverse investments, such as leisure or soccer. All this is sure to be sadly familiar to the reader.

Ah! And I forgot, so that we can identify ourselves completely: it has an immense bank debt. In this case the gigantic figure of 300,000 million dollars.

The misfortune is that perhaps this is the largest Chinese real estate company with problems, but in China, there are countless similar smaller companies the likes of Evergrande.

But as in all places, the guilt falls on several different heads. The real estate market has exploded among other things because the government has encouraged it. The policy of Xi Jiping, the charismatic Chinese president, was to encourage a large population transfer from the center of the country to new cities, mainly coastal, but many of these new cities have become *ghost cities*.

"Chinese ghost towns have become a tourist attraction. If it were only that, nothing would happen, but they will hit us through no fault of our own."

The icon of this real estate disaster is a city called Ordos Kangbashi, in a Chinese region of Inner Mongolia. This city is prepared to receive 300,000 people. At present, although there are no official statistics (I believe that due to bullfighting shame), its census may not even reach 1,000 inhabitants.

Luckily for us, the vast majority of this huge debt is in the hands of Chinese banks, but we Westerners will not get away with it, and now I am going to explain why.

The asset bubble created, of which Evergrande is only the tip of a large iceberg, has burst because those low-quality assets that neither will find a buyer nor find a refinancer, so the Chinese government has only two alternatives left, none of them pretty: one, let it fall, generating a financial cascade like the one we had in the West in 2008, or on the contrary, rescue it, that is, socialize its debt.

"You will admit that it sounds sarcastic that the head of the communist countries has to socialize the private debt of their private companies."

But let no one panic for the moment. Although it is almost funny that the head of the communist countries has to socialize the private debt of their private companies, the Chinese government, through its central bank, has enough muscle to do so. It has long had 3.2 trillion in foreign currency on its balance sheet, but its use for this purpose will immediately lead to a devaluation of the Yuan, at a time when the change in the growth model has drastically lowered its trade value, going from that of a 10% positive, to less than 1%.

"A devaluation of the Yuan to support the real estate fiasco will impoverish the Chinese population, still light years away from the American one."

A devaluation of its currency will drastically affect the purchasing power of its citizens, whose average per capita income is still four times less than that of the US counterpart. And this in the country of two faces: economic freedom in exchange for citizens accepting political oppression.

As with most icebergs, we still do not know its true size. Here, and only for the moment because of what little we know, let's hope it doesn't sink us like the Titanic, because we're going to see it live firsthand. So, for now let's put on our wetsuits, and soon we'll see if we need to get the complete diving equipment out of the drawer.