Geneva, le 20 octobre 2021

State media reported that a meeting of the Chinese Communist party's Central Financial and Economic Affairs Commission on Tuesday, chaired by Xi, had emphasized the need to "regulate excessively high incomes and encourage high-income groups and enterprises to return more to society".

The committee added that while the party had allowed some people and regions to "get rich first" in the early decades of China's reform and opening period, it was now prioritizing "common prosperity for all".

Financial Times, August 18, 2021

Dear Sir, Dear Madam,

For the first time in a little while, volatility reared its head again in financial markets, in particular during the month of September. While negative returns on most indices (MSCI World -4.29%, S&P 500 -4.76%, Stoxx Europe 600 -3.41%) were relatively muted, some stocks have had a particularly hard time during that month. Notable among those are some of the biggest winners of 2020, such as Zoom Communications down 48% compared to a year ago, for example.

As always, many reasons can be found for why stocks and indices go up and down, but it seems pretty clear the latest anouncements from the Chinese leadership (see above) had a particularly negative impact on many companies, in particular those based in China and those with large exposure to the Chinese market.

We have already talked with many of you about all things China, but we have not addressed the issue in detailed, written form yet and we think these latest events deserve further scrutiny. First, a bit of context: over the past fifteen years, we had many clients coming back from China who were completely bedazzled by what was happening over there: "well, it doesn't take them years to build a new railway, they just raze the villages on the way and build it". Or "when they decide to do something, they do it right away, without endless discussions and opposition from many quarters".

Well, yes, that's obviously the whole point when you run a communist dictatorship: your citizens don't get to form opposition groups, lobbies, organize protests or do other annoying things we must face in our democratic nations. So yes, things get done faster. Not necessarily better, but definitely faster.

What we always tried to point out to our clients on this issue is that the almost absolute power the Chinese state holds over its citizens, is also held over its companies. This means that Chinese companies, innovative as they might be, are not necessarily run for the benefit of shareholders, but rather for the benefit of the state (better not criticize the government on WeChat, China's equivalent of WhatsApp, or the police might just come down to your place for a not necessarily friendly chat). Certainly, one can criticize shareholder capitalism and its many flaws but we are certain it is almost always a hundred times better than state-run capitalism.

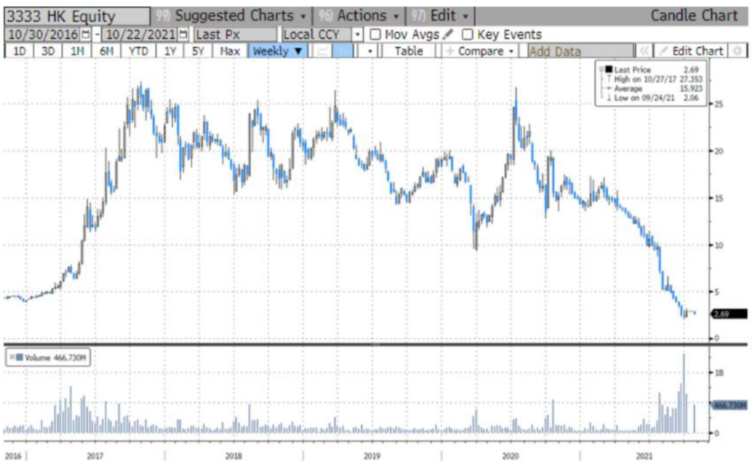
What made some Chinese companies, such as AliBaba, Tencent or Baidu, even more enticing to many clients (and many Western investors, such as banks) was that they were (drumroll…) NATIONAL CHAMPIONS. No competition from those pesky American kids, such as Amazon, Google or Facebook: they were simply not allowed to operate in China. Little to no competition means juicy profit margins, but what almost everyone forgot was that, what the Chinese state creates, it can also destroy.

And it did destroy during the last quarter. To be fair, this should not come as a great surprise, as the Chinese leadership has always clearly explained its main goals. "Common prosperity for all" is not a brand new theme, it will just be more thoroughly enforced. And, granted, there were excesses, in particular in the private education sector. Stories of teachers not doing anything during their courses at public schools but advising their students to subscribe to private classes in the evening, at which they would actually teach, clearly threatened the objective of equal opportunity for each child to attend the best universities.

Other measures, which even some in the Western world have applauded, include limiting online video gaming for kids under 18 to just three hours a week. The fact that this policy can actually be enforced by the state, through use of facial recognition technology, should be frightening. Therefore, even though there were some excesses, the Government's interventionism allows for questioning.

The most impactful decisions were already taken a year ago, when new regulations for real estate developers, particularly in terms of leverage, where enacted. They were called "The Three Red Lines" and were essentially balance sheet financial tests. Foremost among real estate developers, Evergrande has been, for now, the most impacted by these red lines and is currently trying to escape bankruptcy, with more that USD 300 billion of debt outstanding inside China (and USD 30 billion outside).

Despite the sizable sum of these debts (and other real estate developers will probably suffer as well), this is not a "Lehman Moment" (in reference to Lehman Brothers' bankruptcy, which many point to as the trigger for the great recession of 2008). You can see the chart of Evergrande's share price on your left.



This cannot happen the same way, because China's financial system is mostly closed off to foreigners and thus there can be no real contagion outside of China. While it is not as bad as Lehman, the implications for China's economy are staggering and the full ramifications are yet to play out.

Let's take a step back. Chinese figures should always be taken with a grain of salt, but to the best of our knowledge, the real estate sector in China could represent 25 to 35% of GDP, a number much higher than anywhere else in the world, even at the lower range. More staggering still, real estate ownership represents, for Chinese people who own any, about 80% of their wealth. Again, this is around twice as much as anywhere else in the world.

In this context, the Chinese leadership has always understood that real estate would eventually turn into the Achille's heel of the system. Any slowdown, any lower prices, and both GDP and its citizens confidence in the system could nosedive.

There is, however, a wide gap between understanding the problem and addressing it. In a country with no local tax system to speak of, local governments had to rely mainly on selling land to finance local services. Killing that cash cow meant the central government would have to step in. Furthermore, every time the central government tried to slow down the red-hot housing market, the economy hit stall speed (not surprising given the size of the sector, as mentioned before).

So, much like in our maligned democratic societies, the problem was swept under the rug, to be addressed at some point in the future. Hence, a difficult problem to solve has become, with time, an almost unsolvable one, because it is so much bigger now than even five years ago. Bailing out everybody will be very, very costly.

This is even more so because, unlike in most of the Western world, real estate purchases have to be paid down up front, when the sale contract is signed but before anything is built. Here, you pay 10% down with the other 90% to be paid once the apartment or house is built and ready to be lived in (the percentages may vary, but you get the idea). This has very important implications because, coming back to the USD 300 billions of debt, it means debtholders cannot be given a piece of real estate instead of repayment because the piece of real estate (if it has been constructed, which is yet another problem) already belongs to somebody who paid the full price for it.

It is ironic that policymakers in China have studied almost endlessly the Japanese bubble of the 1980s in the hope of not repeating it, and yet here we are. As a reminder, the Japanese bubble that popped in late 1989 is the mother of all modern bubbles. On the equity side, shares were valued at twice the valuation at the top of the Nasdaq bubble (100x earnings vs 50x in 2000) and on the real estate side, well, it's even more difficult to describe. Suffice it to say that mortgages were structured to be repaid by the second generation (the sons and daughters of those who took out the mortgage) and that the gardens of the Imperial Palace in Tokyo were worth more than the whole of California's real estate. When the bubble burst, it destroyed everything in its path and now, more than thirty years later, Japan has not fully recovered yet.

Things have not gotten so out of hand in China, but the problem is that the numbers are so much bigger that it doesn't really matter about control, but rather the effects. Something we should also mention is that the Chinese government has also tried to enforce lower real estate prices across the board (sometimes by 30%). As a result, real estate transactions have crawled to a halt and uncertainty is very high.

This could be a toxic cocktail in a country where real estate plays such an important role, both in terms of GDP as well as in terms of the wealth effect. Indeed, if 80% of your wealth is in real estate and you suddenly realize it could be worth 30% less, saving more and spending less seems like an intelligent thing to do. Replicate it for every Chinese homeowner and the impact could be gigantic.

We have long told clients that revolution in China would not come because citizens would flood the streets to demand a more democratic society (the lessons of Tiananmen 1989 have been learned) but because their real estate wealth would be worth less. Already, footages of angry investors storming Evergrande's offices can be seen on social media. So, who knows what will happen? Certainly not us, but 2022 will be fascinating

All the best,

Julien Devaux
Chief Investment Officer
FFM Gestion