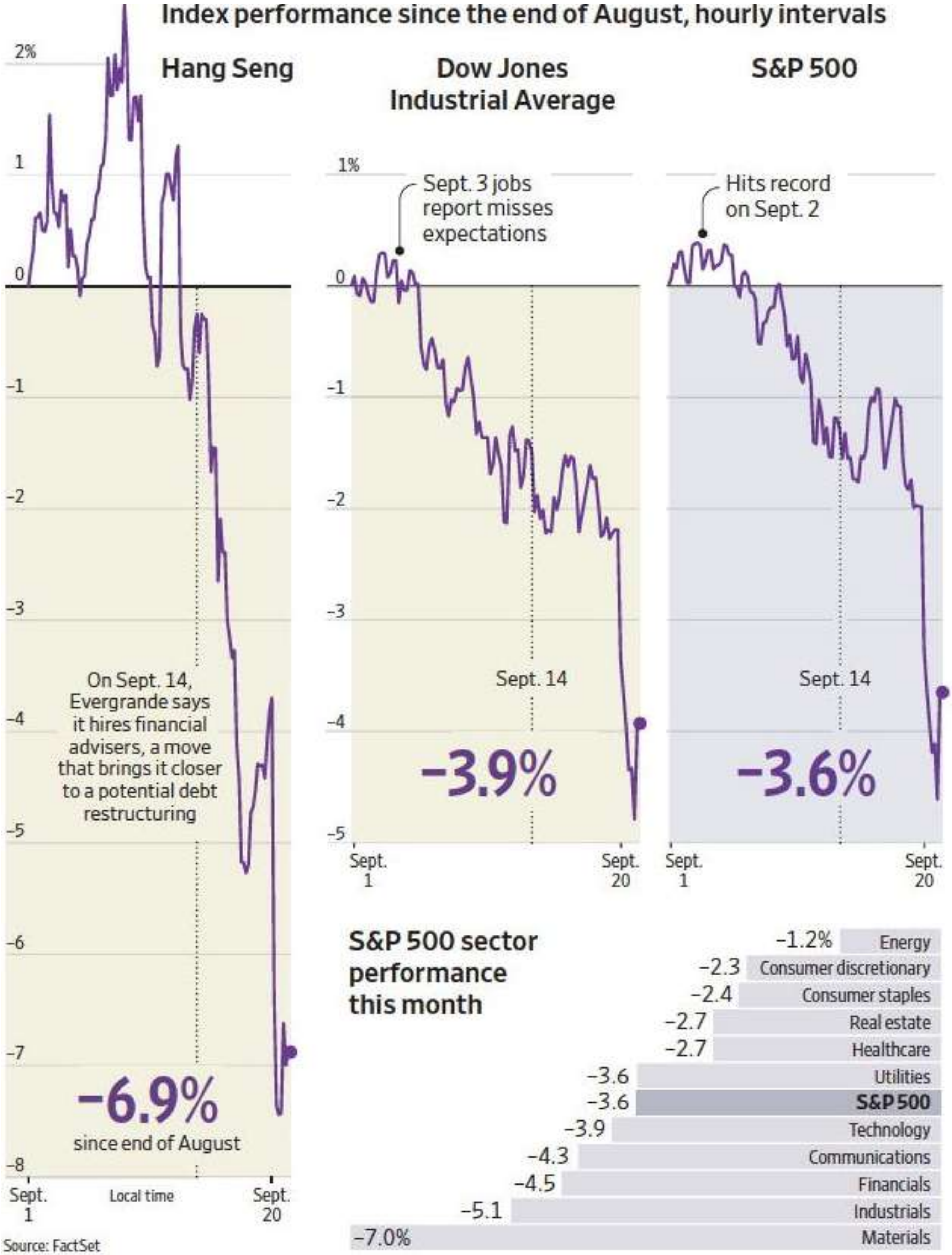
China

The lead story from Tuesday's WSJ:



Stocks Record Biggest Slump Since Spring

Concerns over Chinese property market send indexes down broadly, snapping recent calm

BY GUNJAN BANERJI AND ELAINE YU

Worries about spreading troubles from China's property market snapped an extended streak of calm in stock indexes and sent the S&P 500 to its worst day since May.

The growing concerns over property developer China Evergrande Group, which has the biggest debt burden of any publicly traded real-estate management or development company in the world, triggered a rush Monday out of riskier assets like stocks, oil and bitcoin, and into safer ones. The Dow Jones Industrial Average dropped 614.41 points, or 1.8%, to 33970.47 ....

The S& P 500 dropped 1.7%, and the technology-focused Nasdaq Composite Index fell 2.2%, after being down more than 3% earlier Monday afternoon. The S& P 500 and Nasdaq are on track for their worst months since last September, while the Dow is headed toward its biggest monthly decline since October 2020.

The punishing selloff accelerated midday, sending the Dow down as much as 972 points at its low of the session, before the blue-chip gauge pared some losses.

The declines were broad, with all 11 S& P 500 sectors recording declines, and only five stocks in the entire index—four of them airlines—eked out a gain of more than 1%. The selloff also was global: The Hang Seng Index in Hong Kong fell 3.3% to its lowest close since last October, while the Stoxx Europe 600 dropped 1.7%.

Market participants increasingly worry that Beijing will continue to rein in various industries and that it will let Evergrande, which owes tens of billions of dollars to investors around the world, fail and inflict losses on its shareholders and bondholders. ...

Concerns over Evergrande struck as investors had grown more cautious about the outlook for stocks, after a booming rally for much of the year. ...

Money managers have said valuations look elevated and pointed to signs that the economic recovery in the U.S. has lost steam as the Delta variant of the coronavirus spread. While the Evergrande issue might have been the spark for Monday's selloff, worries about the global economy and the runup in the stock market this year had been percolating.

For much of the summer, individual and institutional investors piled into the stock market. Market volatility was low as investors were quick to buy every small dip in share prices, a favored strategy that helped the broad stock-market gauge recover from its March 2020 low and has sent it up 16% this year.

The mood shifted in September. Many investors were bracing for more volatility in the autumn, and some on Wall Street said they were forecasting lackluster returns through the rest of the year. Analysts at firms including Citigroup, Deutsche Bank and Bank of America published notes this month cautioning about risks in the U.S. stock market, while others said they expected economic growth to soften.

Some forecasts have grown even darker. Morgan Stanley strategists warned on Monday about the growing likelihood of more than a 20% decline in the S& P 500.

Investors have been grappling with a number of risks, including higher inflation. This week, investors plan to be closely tracking the Federal Reserve's monetary policy meeting and how the central bank will navigate dialing back its support to financial markets. ...

Yields on 10-year Treasurys slipped to 1.308% from 1.369% Friday as bond prices rose, recording their biggest one-day yield decline since Aug. 13.

Shares of energy and financial companies were among the worst performers on Monday, and companies in sectors that are exposed to China's resource-hungry economy experienced big declines. ...

Hong Kong-listed shares of Evergrande, which said Sept. 13 it was facing unprecedented difficulties, declined more than 10% to their lowest close in a decade. Mainland Chinese markets were closed for a holiday. ...

China's leaders are pushing Evergrande and other real-estate companies to reduce their debts, as they try to tame the mainland's housing markets after years of runaway growth. ...

JPMorgan analysts said in a note Monday that the market selloff was exacerbated by technical factors such as options hedging as well as poor liquidity. They considered Monday's selloff an "overreaction." And some investors did step in toward the end of the trading session. The S& P 500 was down 2.9% at its low of the day, the largest intraday decline since January, before paring some of those losses.

"Our fundamental thesis remains unchanged, and we see the sell-off as an opportunity to buy the dip," wrote a team led by JPMorgan's Marko Kolanovic in a note Monday.

From Wednesday's The Morning:

The Evergrande troubles

I was sitting at a stoplight in Beijing when I first noticed the young men who would walk in between cars and hand out brochures to drivers. I rolled down the window and took one. To my surprise, it was a for-sale advertisement for apartments in a newly constructed building.

This was in 2010, when the American economy was still enduring the aftereffects of its burst housing bubble. I had covered the rise of that bubble, and the fliers in Beijing reminded me of Florida during its frothiest days: The Chinese real-estate market had grown so hot that the people were marketing apartments at red lights, as if buying one were as common as buying a soda.

There were many other signs of a property bubble during that trip. On sidewalks in Shanghai, I walked past real-estate agencies that had set up outdoor tables, to accommodate all of the demand. During my first night staying at a new hotel in the small city of Wuqi, I didn't see a single other guest — in the lobby, restaurant or elevators. Around this same time, Jim Chanos, a prominent American investor, warned that China's real-estate excesses had placed it on a "treadmill to hell" and that the bubble might burst at any point.

But the bubble did not burst in 2010. It did not burst in 2011, nor has it burst in the decade since — unless, that is, it's starting to do so this week.

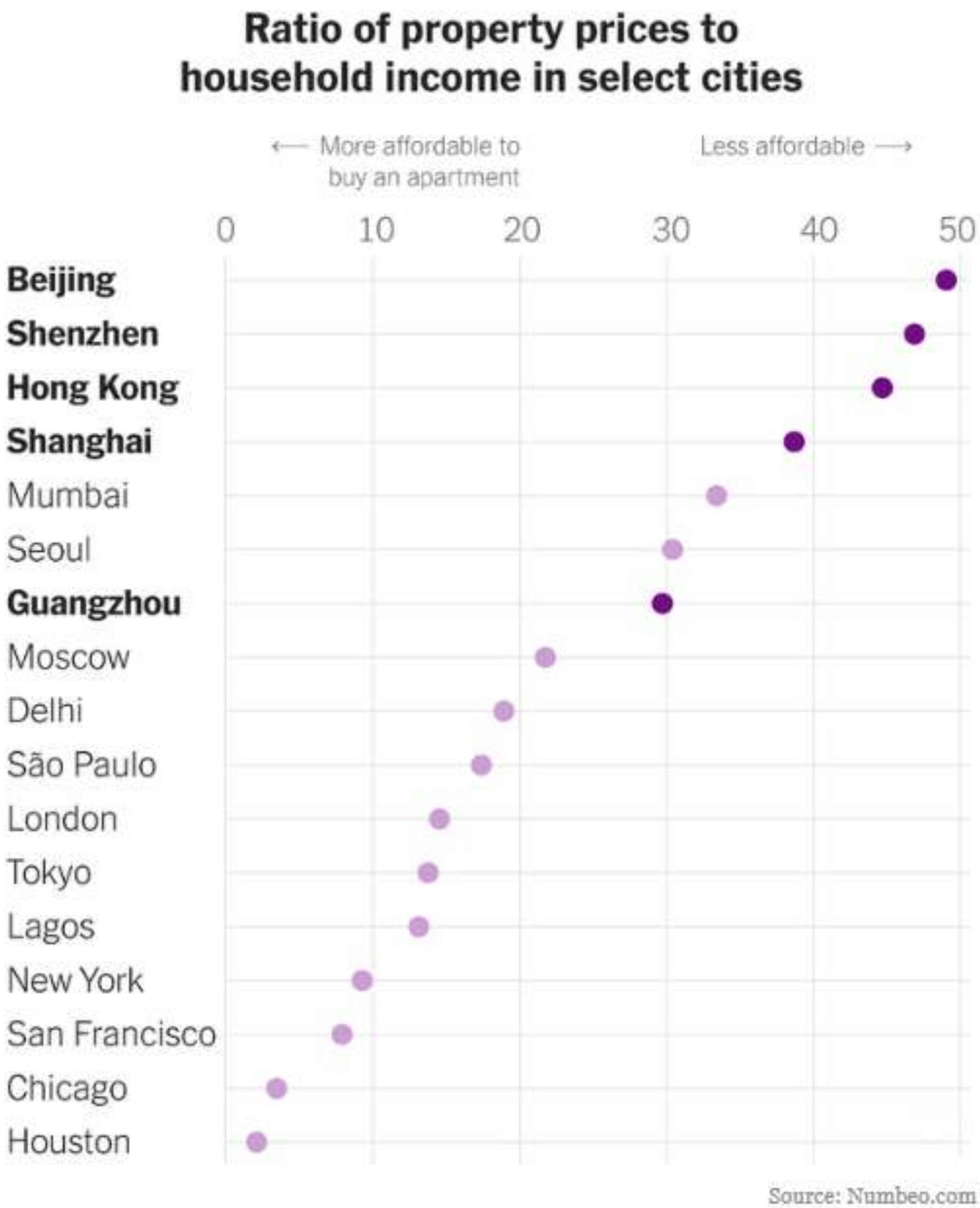
Signs of froth

The troubles of China Evergrande, one of the country's largest developers, have focused the world's attention on China's housing market. A recent slowing of the real-estate sales in China appears to put Evergrande on the brink of insolvency. ...

This week's news sent stocks around the world falling, with investors worried that the failure of Evergrande could set off a cycle of defaults among banks and other companies. "Every once in a while a company grows so big and messy that governments fear what would happen to the broader economy if it were to fail," my colleagues Alexandra Stevenson and Cao Li have written. Evergrande, they explained, "is that company."

Some other Chinese developers may also be in trouble. And by almost any measure, Chinese real estate is suspiciously expensive.

Consider the median price of homes in China's largest cities relative to the median incomes in those cities — a classic measure of housing valuation (and one that was blinking bright red in the U.S. before the housing bubble burst):



Chinese real estate, as Matthew Brooker of Bloomberg Opinion argued recently,

… is a bubble of epic proportions, one that by various metrics easily overshadows the pre-global financial crisis run-up in U.S. property values (which burst with such disastrous consequences) or the unsustainable booms in European countries such as Ireland and Spain. It stands comparison with the Japanese real estate bubble of the 1980s, which helped send the country into at least one "lost decade" when it finally burst in the early 1990s.

Andy Xie, an economist in Shanghai, put it this way in The South China Morning Post:

It is becoming increasingly popular to argue that the Chinese government has figured out a way to sustain the bubble forever. Beijing has many abilities, but making a bubble last forever isn't one of them. For thousands of years, Chinese emperors tried to achieve immortality by swallowing all kinds of stuff. None worked.

Given all of this, it's easy to see how the bubble warnings of a decade ago — like Chanos's — may not have been wrong so much as they were early (for short sellers like Chanos, being too early is being wrong). A similar dynamic played out in the U.S. a decade and a half ago: Economists who looked like alarmists in 2005 turned into prophets by 2008.

Then again, China is different from the U.S., Europe and Japan in some important ways. Even though China's economy has slowed in recent years, it is still growing more quickly than richer economies are. As a result, China can partly grow into its housing bubble. ...

China's government also has large cash reserves and has been willing to do whatever is necessary to avoid an economic crisis. Over the past several years, the government has taken steps to cool the market, like restricting sales and home loans in some situations. Those moves have slowed down price increases in recent years.

"The longevity of the boom suggests that the market is more complex than its depictions as a bubble suggest," The Economist magazine has written.

A soft landing?

During my trip in 2010, I sat down with Guo Shuqing, who was then the chairman of China Construction Bank and is now the country's top banking regulator. He agreed that China's economy suffered from imbalances, including too much construction. Still, he added, "I think we have plenty of time, plenty of tools and plenty of instruments to make a soft landing and a smooth transformation."

Based on standard economic measures, China still has not done nearly enough to fix its imbalances — and it's usually a mistake to bet against the normal rules of economics. But China's unmatched size and long record of growth offer reasons at least to wonder whether this bubble really is different.

From Friday's Signal:

Will Evergrande be China's Lehman Bros? Chinese authorities are bracing for the increasingly likely default of Evergrande, the country's most indebted property developer. If Evergrande — a gargantuan corporation with properties in 200 cities across China — stiffs its creditors, that'll send shockwaves throughout the country's financial system, and the wider Chinese economy and society. The possible ripple effects on home buyers and countless companies and individuals that do business with or are owed money by Evergrande have invited comparisons with Lehman Brothers, the US investment bank whose 2008 collapse triggered an

American financial crisis that quickly spread to the entire world. Although in principle authoritarian China has ways of containing the fallout, the potential for social unrest is real — and opacity could make it worse. More broadly, the demise of such a big player in the country's once-booming real estate market, which accounts for over 7 percent of GDP, would expose the shaky foundations of China's debt-driven economic growth model, eroding confidence in China both at home and abroad.

An update on Evergrande from the front page of yesterday's WSJ:

Evergrande's Bondholders Are Left In the Dark on Payments

*By **Serena Ng, Alexander Gladstone, Gregory Zuckerman** and **Justin Baer***

Global investors who own China Evergrande Group's U.S. dollar bonds hadn't received an interest payment from the property giant by Thursday's deadline, said people familiar with the matter.

Evergrande was on the hook to make $83.5 million in coupon payments by Sept. 23 on dollar bonds with a face value of $2.03 billion. The company could make the payments belatedly, and it has a 30-day grace period before bondholders can call a default.

A missed payment would set the stage for what could be the largest-yet dollar-bond default by a company in Asia. ...

Thursday's payment deadline became a focal point for global investors after Evergrande's liquidity worsened dramatically over the summer, leading to construction halts at some of its unfinished apartment complexes and sharp sales declines. As recently as June, the company had emphasized that it had never missed a bond payment since its founding in 1996.

On Wednesday, Evergrande's flagship property business in mainland China said it had privately negotiated with onshore bondholders to settle a separate coupon payment on a yuan-denominated bond. The developer didn't say if that payment, equivalent to about $35.9 million, would be made in cash or other assets. Evergrande's beaten-down shares fell 11.6% in Friday trading in Hong Kong, and are down more than 84% this year.

Chinese authorities have asked local governments to prepare for the potential economic and social repercussions that could result from Evergrande's downfall, The Wall Street Journal reported earlier on Thursday. That indicates Beijing is reluctant to bail out the developer, but wants to avoid a disorderly unraveling that could create social instability or serious problems for ordinary people who could be affected by the company's failure.

Shenzhen-headquartered Evergrande, the world's most indebted real-estate developer, is China's largest issuer of junk-rated debt, with around $19 billion of publicly traded dollar bonds outstanding. Prices of some of those bonds had earlier plunged to around 25 cents on the dollar, reflecting investors' extreme pessimism about Evergrande's ability to repay its debts. ...

Evergrande's troubles have captivated market participants all over the world because of the developer's outsize position in Asia's credit markets and China's overheated housing market.

Thirteen years ago this month, when Wall Street firm Lehman Brothers failed to secure a U.S. government rescue and defaulted on its borrowings, it sent shock waves through global stock, bond and money markets as a range of asset prices tumbled.

This time, global investors have had months to prepare for an Evergrande failure. The company's stock and bond prices began sliding during the summer, when the developer's heavy discounting of apartments on sale helped spark concerns it was under pressure to raise cash to pay interest bills and other expenses.

Evergrande was recently China's largest developer by contracted sales, and reported the equivalent of $111.9 billion in such transactions in 2020.

It has built residential complexes in every Chinese province.

Many buyers of its apartments made large cash down payments or paid up in full for homes that were scheduled to be completed in a few years. Evergrande has presold more than 1.4 million apartments valued at $200 billion that it has yet to finish, according to estimates from research firm Capital Economics.

It remains unclear how Evergrande will resolve its massive liabilities, which totaled $304 billion at the end of June, including $88 billion in interest-bearing debt. The developer owes large sums of money to suppliers of building materials and contractors that were constructing its apartment complexes, and recently resorted to paying some of them with unfinished apartments when it ran short on cash.

Banks that lent to Evergrande and investors that bought its securities could still incur some losses, but many market participants believe that a government-led restructuring will prevent a collapse of the company and protect the interests of home buyers and its suppliers. ...

Our often repeated concerns about China however, go much deeper than its real estate bubble:

Xi Jinping's disturbing Maoist turn

Opinion by David Ignatius
Columnist

September 21, 2021

Anyone who has visited China over the past several decades has heard anguished stories from Chinese friends about the results of Mao Zedong's social engineering in the Great Leap Forward and the Cultural Revolution. China spent 40 years recovering from those disasters to become a great, modern nation.

So, I can almost hear the gasps inside China, from the generation that lived through the nightmare years, as President Xi Jinping has moved down a Maoist path this year toward tighter state control of the economy — including "self-criticism" sessions for Chinese business and political leaders whose crime, it seems, was being too successful.

Xi's leftward turn represents a major change in the management of the Chinese economy, in the view of a half-dozen experts I've consulted over the past week. It has the idealistic goal of "common prosperity" and a fairer distribution of China's new wealth. But Xi will drive these changes using the ruthless instrument of an authoritarian, one-party state — and you can already see the purges and figurative "dunce caps" for those he views as obstacles.

The Chinese leader speaks internally of "amalgamation" of the public and private sectors, according to Christopher Johnson, a former top CIA China analyst who now heads the consulting firm China Strategies Group. Johnson describes an explanation often heard in elite circles: "Xi wants the state sector to have more market discipline, and the private sector to have more party discipline." The result is a severe squeeze on what Xi views as "undisciplined" entrepreneurs.

The best account I've read of Xi's plans was an article Monday in the Wall Street Journal by Lingling Wei, the paper's senior China correspondent. She described a campaign that has included more than 100 regulatory and policy directives over the past year that have shattered the power of the companies that had dominated China's new economy — the Internet giants Alibaba and Tencent, and a real estate behemoth called Evergrande. Xi has also attacked gaming and education companies that he thought were skewing the values of Chinese youth.

The most chilling detail in Wei's account involved Vice Premier Liu He, a market advocate who has over the past decade been China's most important contact with the West. The article noted that Liu offered "self-criticism" for allowing the ride-sharing company Didi to float a $4.4 billion IPO this summer. This humiliation of a senior official was an echo of Mao's Cultural Revolution, which eviscerated China's educated middle class in the 1970s.

Xi is a cunning and ruthlessly successful politician; since taking power in 2013, he has purged a generation of leaders in the Communist Party, the military, and the intelligence and security services to gain absolute control. His hubris is that, like Mao, he now seeks to become a man-God, whose thoughts are holy writ.

Xi's unabated hunger for power is evident in his drive for a third term as party leader. That would break the two-term rule that has prevailed in China's modern history and provided the checks and balances of group leadership. "China had solved the major problem of a one-party state — succession. Now they are un-solving it," argues a former top-level U.S. national security official.

To drive his internal revolution, Xi has his own vanguard organizations. One is the party's United Front Work Department, which earlier organized campaigns against Uyghurs, democrats in Taiwan, foreign critics in the West and other "threats." Another is the party's Central Commission for Discipline Inspection, which organized the purges of the past decade under its chief, Wang Qishan, who may be Xi's most decisive deputy.

When Wang left that post in 2017 and became a vice president without portfolio, an intelligence source tells me, he was assigned the job of breaking dissent in Hong Kong; now, ominously, it's said he has been assigned the Taiwan file.

Xi's crackdown has rocked the Chinese economy. The top six technology stocks have lost more than $1.1 trillion in value over the past six months, according to Kevin Rudd, a China expert and former Australian prime minister. Jack Ma, the brilliant founder of Alibaba, has been humbled, and prevented from making public comments. Most destabilizing is the fragility of Evergrande, the debt-laden and wildly overexposed real estate developer. Fears that it might default on tens of billions of dollars in debt spooked global financial markets this week.

Xi's campaign to remake China — from the video games people play to the ways children are educated — was explained in a Sept. 9 report by The Post's Lily Kuo. The warning lights are blinking red, so to speak.

Xi is animated by what he has called his “China Dream,” of a nation of unparalleled wealth and power — and also the egalitarian ideals of socialism. His problem is that, like Mao and other visionaries, he has a messianic streak that could prove destabilizing for the world and downright toxic for China.

Our thoughts

	M*	Total Assets	China	Hong Kong
WCMSX	5	1.0	0.0%	0.0%
VIISX	4N	3.2	2.9%	0.2%
GPIIX	4	1.1	4.5%	0.9%
OBIOX	4N	0.4	1.2%	0.0%
VSS	3G	9.9	5.6%	0.7%

HCM clients' exposure to China is limited to the 4 OEFs shown to the right in order of when they were initially purchased, beginning with the most recent. VSS, Vanguard FTSE All-World ex-US Small-Cap ETF, has been added as the most appropriate benchmark. As a reminder, "Morningstar rates mutual funds and ETFs from 1 to 5 stars based on how well they've performed (after adjusting for risk and accounting for sales charges) in comparison to similar funds and ETFs. Within each Morningstar Category, the top 10% of funds and ETFs receive 5 stars and the bottom 10% receive 1 star. Funds and ETFs are rated for up to three time periods, three-, five-, and 10-years, and these ratings are combined to produce an overall rating. Funds and ETFs with less than three years of history are not rated." When followed by a Morningstar Analyst, their Rating (G=Gold, S=Silver, B=Bronze, N=Neutral) is also provided. " It "is a forward-looking analysis of a fund’s likelihood to outperform." They now focus on 3 (Process, People, and Parent) of their 5 (which also include Performance, and Price) key pillars. "A fund that receives a medalist rating of Gold, Silver, or Bronze, is expected to outperform similar funds over a full market cycle." Total Assets are in Billions. Morningstar's graph below shows the relative performance of the above funds starting @ $10,000 at WCMSX's inception.