"Five Minutes With Scott Colbert, CFA"

Is This China's Lehman Moment?

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Scott Colbert:

Good morning. It's Monday, September 20th. We are about an hour into the trading day…so far today. To bring you up to speed so far in what's been happening in September. Basically, September has been a month of cooling. We've noticed a marked decline in the U.S. rate of growth…sparked of course by a local rise in COVID cases as well as a global rise…it's disrupted supply chains and pushed back on retail sales…most notably you see this in the auto sector. But in general, the supply problems that we have around the world are still every bit as hard…every bit as bad as they've been basically since last March. At that, some anecdotal evidence suggests that perhaps it's even just as bad with Vietnam and Malaysia almost entirely shut down given their reaction to the COVID crisis.

Financial markets may have reacted as you might expect, and fallen a little but in sync with this slow-down in growth. The S&P 500, which was up over 20% on a year to date basis, including dividends, was down to about 19% as we closed Friday. International markets have been impacted a little bit more than this. No. 1 we've had a strong dollar, so that reduces some of the returns overseas. But No. 2 most importantly has been a focus on the Chinese economy, and the clear troubles they are having over there.

This morning, when the financial markets woke up, the headline story was about a property development company called Evergrande in China. Evergrande sounds like a nice name, but at the margin they are China's second largest property developer, and by far the largest debtor in China. They owe $305 billion dollars…mostly to Chinese banks and citizens, but they've even borrowed $16 billion dollars globally in U.S. dollars…and even have some Eurodollar amounts outstanding as well. So Evergrande is a large debtor. To put that in context, Lehman Brothers at the peak of the (subprime) loan crisis was a $700 billion dollar asset firm with about $590 billion in debt. If there is a difference between Lehman and Evergrande it's that Lehman had a lot of liquid assets. Most of their assets were bonds. And, of course, about half of them were subprime bonds. But they also had a bunch of liquid assets.

Evergrande is a property developer. What they own are those cities with apartment complexes and housing developments and they are very illiquid. They have a $181 billion of property under development. So, this is a big deal for the Chinese stock and stock market…of course it's been reflected…Evergrande stock itself is down 89% over the last year…and their bonds have been falling in price very precipitously since about June. So, it wasn't like this was an unexpected event when we woke up today and found out they weren't going to make their bond payments. But nonetheless, it's a sign of contagion or worry with the Chinese economy. And it's reflected in the Chinese stock market in aggregate, which is down about 50% year to date, and while it's closed for a holiday today, when it opens tomorrow, it will probably be down another 3 or 4 percent, because we saw the Hong Kong stocks were down about 3 or 4%.

So, what does this mean in terms both for China and a global perspective? Well, No. 1, China has been working to de-lever their economy from one that's been simply a growth-led internal investment, plant, capital, equipment, and infrastructure to one that is more self-sustaining. And the Chinese government will probably get what they want. We've already seen their focus turn from Alibaba and the IPO Ant to the focus on after school stocks to a focus on gaming stocks to a focus on gambling stocks. And now toward one on property development.

With the Chinese stock market cooling, the Emerging Market stock indexes are now negative on a year to date, pulling financial returns around the globe down a little bit. As we used to say here in the United States, when the United States would sneeze, the rest of the world would catch a cold…it's probably something more along the lines of "if China is going to catch a cold, the rest of the world might catch a flu." China has been the big driver.

Internally, here, when we look at our own portfolios and we look at economic growth, we really have to think of this situation in China in three terms. No. 1, is this just self-contained largely because of the select number of Chinese stocks? I think our answer to that is "no." No. 2, is it mostly contained to China? And our belief is it probably is a given that so much financing in China is internal. There aren't a lot of U.S. dollars or European dollars from a debt perspective flowing into China. It's mostly equity investment. So, we think the risk of global contagion is modest, but we can't rule out that this is something much much bigger.

What will this mean for our financial markets? Well, it probably takes a lot of the froth out of the market as we saw the S&P 500 down about 1 ½ percent and the Dow is down about 500 points so far today so far in its trading. We've seen interest rates fall just a little bit. We will probably likely see inflation cool. Iron ore prices have collapsed nearly 50% in China since the Evergrande situation basically became public in early June. And even copper prices are off about 18%.

So, at the margin with China being 71% of our GDP, and the second largest country around the world, as their growth cools, so will the global economy. And it will probably have some type of impact, in aggregate, on our financial markets.

We'll be back in a couple of weeks to talk about these events and how they are impacting the economy and more importantly how they are impacting your portfolios.

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