The Evergrande Crisis is Not China's "Lehman Moment"

Summary

- China's "Lehman Moment" is exaggerated. The contagion worry is not showing up in the broader credit markets, which have in the past served well as red flags for broader credit crunches.
- There have been more positive signals over the past few days towards our base case scenario i.e. orderly debt restructuring for Evergrande and broader easing if necessary.
- China assets still offer compelling portfolio diversification benefits. We maintain our positive view on China A-share equities, which would benefit more directly from the anticipated selective policy easing in 4Q.
- The corrections also offer bottom-fish opportunities for selective China corporate bonds with healthy balance sheets when there is more clarity on the endgame of Evergrande.

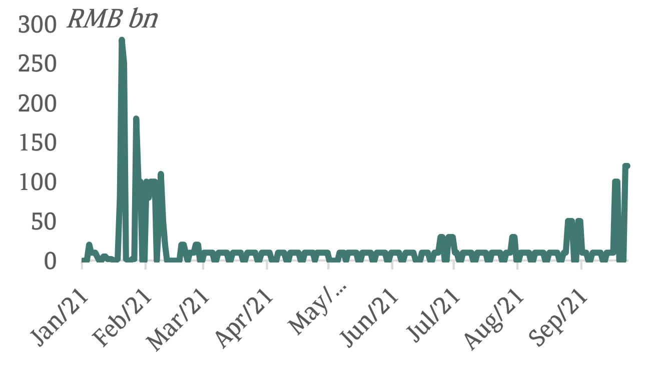
"Lehman Moment" is exaggerated

Market participants continued to assess the potential contagion over a default by the Chinese giant Evergrande as the company is due to pay out interest today. Thus far, the contagion worry is not showing up in the broader credit markets, which have in the past served well as red flags for broader credit crunches. Markets were also calmer than expected after playing down the threat of its troubles becoming China's "Lehman brothers moment".

There have been more **positive signals** over the past few days towards our base case scenario i.e. orderly debt restructuring for Evergrande and broader easing if necessary as we communicated early this week (for details: please click *here*):

(1) The PBoC injected a total of RMB 240bn (USD 37bn) into the financial system yesterday and today after the public holidays early this week.

RECENT LIQUIDITY INJECTION WAS THE HIGHEST SINCE FEBRUARY 2021



Source: Bloomberg, BNP Paribas (WM), 23 Sep 2021
Past performance is not indicative of current and future performance

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(2) Evergrande reached an agreement with onshore bondholders on coupon payment worth USD36m (smaller) due today, while there is another (larger) USD bond coupon payment of USD 83.5m also due today and with more in coming months.

(3) There was news yesterday saying that the Chinese government would restructuring Evergrande into three separate state-owned entities and could be announced within days.

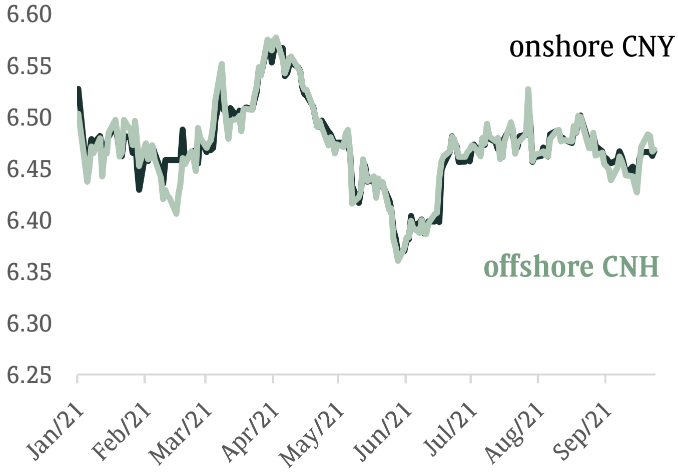
(4) Contagion so far is limited to a few weaker Chinese developers with their high yield bond spread sharply higher, the broad Chinese credit market and EM credit markets are largely stable.

YET TO SEE CONTAGION TO BROADER CHINESE OR EM CREDIT MARKETS

Source: Bloomberg, Goldman Sachs, 22 Sep 2021
Past performance is not indicative of current and future performance

(5) Both onshore and offshore Chinese equity markets saw a rebound today. There were some weakening in CNH (offshore) early this week when the onshore CNY market was closed, while both CNY and CNH stayed calm today.

THE ONSHORE & OFFSHORE RMB MARKETS ARE LARGELY STABLE



Source: Bloomberg, BNP Paribas (WM), 23 Sep 2021
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Regulatory headwinds continue but more easing on the horizon

Some argue that Beijing is stress-testing the system. This is absolutely possible as the authorities could easily ease policies whenever necessary. Although we do not see a turnaround in the regulatory tightening campaign given the central government's longer term objective in achieving "common prosperity", weaker than expected economic data across the board in two consecutive months (bad news) could see more selective easing measures in 4Q (good news) as we addressed this topic earlier this month (for details: please click *here*).

We maintain our view that the Chinese authorities would avoid the worst case scenario of disorderly bankruptcy of Evergrande and other large property developers. Although bond defaults will continue to rise, this has already been reflected in the bond prices of the property developers with weak balance sheets.

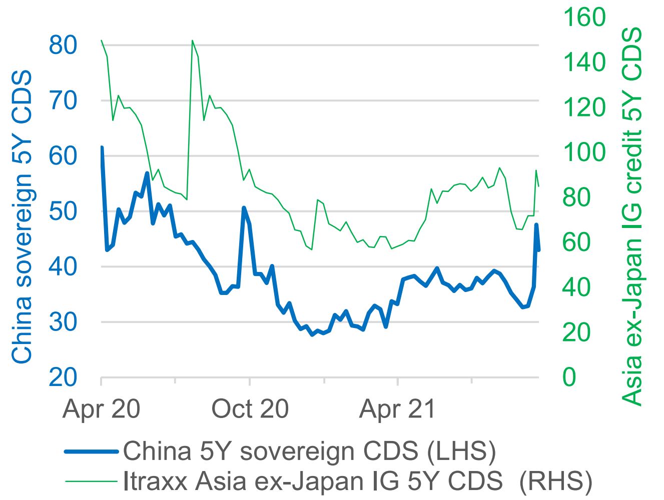
Indicators to gauge the contagion risk?

While many commentators have suggested that the current events around Evergrande could develop into a financial contagion crisis, this is not at all evident in the many market indicators we survey.

To take three clear examples of China market indicators that we are looking at closely at present:

1. **Sovereign and credit CDS indices**: the higher these CDS indices rise, the greater the implied default risk on the underlying bonds. While these CDS indices have risen of late, they remain far below mid-2020 levels.
2. **Equity market implied volatility**: the higher the implied volatility levels on Chinese equity indices, the higher the cost of buying put option protection to cover one's Chinese stock exposure. Again, yes volatility levels have risen, but remain unexceptional, and nowhere near 2020 peaks.
3. **NWM China stress index**: this composite stress index made up of a number of financial market indicators remains very low, not signaling imminent contagion e.g. in the banking system.

CREDIT CDS INDICES: CHINA SOVEREIGN, ASIA EX-JAPAN IG CREDIT START TO TIGHTEN



Source: Bloomberg, BNP Paribas (WM) 23 Sep 2021
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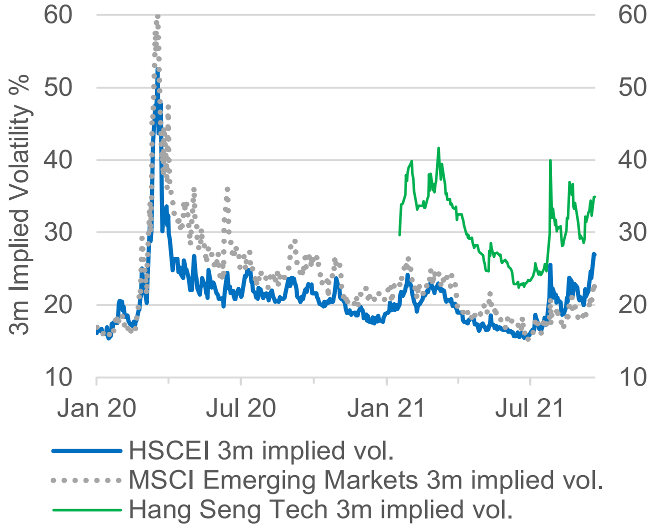
CHINESE. HONG KONG EQUITY MARKET VOLATILITY IS WELL BELOW YEAR HIGHS



Source: Bloomberg, BNP Paribas (WM), 23 Sep 2021
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NWM COMPOSITE CHINA STRESS INDEX IS UNPERTURBED

Source: Bloomberg, BNP Paribas (WM), 23 Sep 2021
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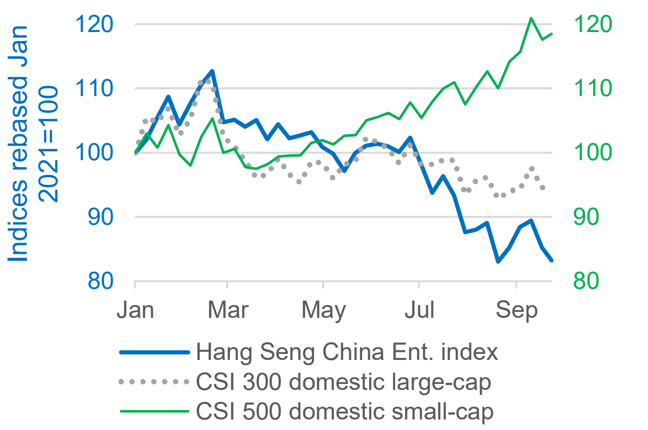
CONCLUSION/STRATEGY - China assets still offer compelling portfolio diversification benefits

- The Fed may start tapering as early as next meeting in November, while policy fine-tuning is expected in China amid slower China growth. The different stage of economic cycle and the ongoing opening up of the Mainland financial markets offer investors attractive portfolio diversification benefits.
- We maintain our positive view on China A-shares in particular mid- and small caps which would benefit more directly from the anticipated selective policy easing. In fact, CSI 500 (+18.5%) has largely outperformed CSI 300 (-5.5%) YTD.
- Sectorwise as mentioned in our previous note, any indiscriminate sell-off would offer medium-term opportunities in sectors with government policy support, such as EV supply chains, semiconductor, renewable energy, high-end manufacturing as well as consumer and healthcare leaders.
- China big tech stocks are already in distressed valuations, probably pricing in more than sufficient on the regulatory changes. Hence, we could see short-term rebounds when there is more clarity on the endgame of Evergrande. However, a sustained rally would need catalysts and is less likely in the near term given the ongoing regulatory tightening campaign.
- The corrections also offer bottom-fish opportunities for selective China corporate bonds with healthy balance sheets. Interestingly, there were strong inflows into Asia high yield mandated funds in recent weeks, indicating global credit investors probably view the market weaknesses as buying opportunities and the rise in China high yield property defaults as a reduction in moral hazard.

CHINA DOMESTIC SMALL-CAPS: A COMPLETELY DIFFERENT MARKET IN 2021



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