A forward view of the global economy and financial markets

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Evergrande or Everbust

"The surest way to ruin a man who doesn't know how to handle money is to give him some".
George Bernard Shaw, Playwright

Source: Wikipedia

In early September the Chinese property company Evergrande announced that sales of its apartments were no longer sufficient to service its huge debts. The company is listed on the Hong Kong Exchange at a price of HK$ 2.54 having fallen from a price of HK$ 25.80 on 3rd July 2020. A fall of just over 90%. This company was in the Global 500 and therefore a number of Exchange Traded Funds hold the shares. However, the largest shareholder is the founder and CEO Mr. Xu Jiayin who still owns over 71% of the shares.

1.5 million customers of Evergrande have paid deposits on apartments that have yet to be built and there are 800 projects yet to be finished, which could mean disaster for all those people. The company is estimated to have liabilities of $300 billion of which $100 billion is in debt owed to bond holders, banks and suppliers. Evergrande owns 1,300 projects in 280 cities across China and employs 200,000 people directly but, indirectly it helps sustain 3.8m jobs in China each year. Outside of property the company diversified into electric vehicles, sports, theme parks as well as a food and beverage company.

One of the more ridiculous projects has been Guangzhou Evergrande football club where $183m was spent on a soccer school and the world's largest football stadium is being built at a cost of $1.7bn.

The Chinese authorities have been trying to get Mr. Xu to reduce Evergrande's debt but, this is too late as the word is out and nobody wants to buy assets that they might be able to acquire far more cheaply after the company has failed. It looks as though the Chinese Government will have to step in to protect individual customers and the banks to maintain confidence in their banking system.

The sad part of this story is that banks continued to lend money to a company with an opaque structure which clearly had a large corporate governance risk due to the fact that the corporate power lays in the hands of one individual. This type of corporate failure is something we have seen time and time again. Just for good measure the credit rating agencies did not reduce the rating to "danger of failure" until after the company announcement this September. Foreign investors own $7, 4 billion of Evergrande's debt and it is unlikely that they will be paid anything but, it is a loss that is manageable. Some analysts think that it will take 10 years to unwind Evergrande's corporate accounts in China.

Will the bankers ever learn that just because a company is big and has a well-known CEO it does not mean that normal lending disciplines can be ignored? This is a company which was 15x leveraged with a negative cash flow in 8 out the last 10 years. Surely a huge red flag? As George Bernard Shaw said, if you lend money to man that doesn't know how to handle it disaster is sure to follow. In this case it will be the third largest corporate failure ever based on current estimates.

Richard Harper
Head of Asset Allocation
GHC Capital Markets Limited

Asset Allocation

In which **Tim Harris**, the Chair of our Asset Allocation Committee, describes the factors influencing our latest Asset Allocation decisions

Signs of slower growth and inflation rising

Investors have been buying-the-dip in global equity markets for many months now. But, this time they must ask, will the faith of policymakers to make good any slowdown in growth hold and will the markets hold current levels or see downside? There has been an almost unprecedented lack of volatility in the leading equity indices. The US market has risen on a consistent line for the past 12 months. Yet the world has become a very different place since the COVID crisis and it is difficult to argue that the trend growth of the global economy has materially improved. Indeed, the way globalisation has gone into reverse argues that trend global growth is impaired and equity markets may not continue to climb at the trajectory of the past year. However, plentiful liquidity around the world has driven asset prices to high levels, and only if that liquidity is reduced will the bubble likely deflate.

Key questions to gauge the risk of downside in equities in the coming weeks

Is global growth momentum lost? Global economic data has lost some momentum in recent weeks. The aggregate index of economic data surprises is at its lowest since June 2020. Economists' consensus forecasts are for a slowing of global growth from 8.5% year-on-year in Q2 to 5.3% in Q3 and economists have trimmed their estimates by around one percentage point in recent weeks. Supply line disruptions, an inflation squeeze on households' real income growth, and selective lockdowns and worries about the COVID delta variant have negatively affected growth. While a few of these issues look like they are solvable, forecasts for growth based on reported data have a third-quarter growth rate of just 3.0% quarterly annualised for developed market economies.

Is corporate earnings momentum lost? Over the last few weeks, there has been a loss of momentum in upgrades to corporate profit forecasts across Europe and the United States. Recent market declines reflect that. Crucially, aggregate consensus earnings forecasts have remained stable, yet there are no signs of significant cuts in projections. In the next few weeks, companies will be assessing whether they need to provide any guidance to the market on earnings revisions as they end the quarter.

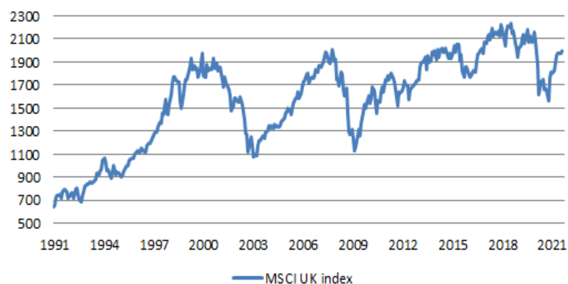
Will there be a gradual tightening of monetary policy? If monetary conditions were measured just in terms of the rhetoric of central bankers, most commentators would admit that global monetary conditions are on a slow, tightening path. The Fed talks about tapering its quantitative easing. The ECB announced that it would moderately slow the pace of its bond purchases in the next three months. The swing central bank could be the Chinese central bank (PBOC). Given the recent very weak economic surveys, the PBOC may ease policy in the coming weeks. They may be inclined to offset the recent domestic weakness and the challenges in the bond market. Investors are on watch for signs of a policy mistake by the central bankers or governments. For example, will the PBOC react quickly enough to a meltdown in the Chinese real estate debt market? Is the UK government too hasty in increasing taxes to pay for the impact of the pandemic on government debt?

After such a strong run, the global equity markets look more vulnerable

However, we believe that the balance of risks will be that investors will again buy the dip. Crucially global demand is still growing. It’s just that suppliers are struggling to meet demand through a combination of supply line problems and shortages of labour, particularly in the United States. Demand growth for a product or service is failing to register as GDP growth due to these likely short-term challenges. As supply bottlenecks ease and more people take up jobs, pent-up demand and low inventories will likely lead to a reacceleration of growth, which would be good news for the equity markets.

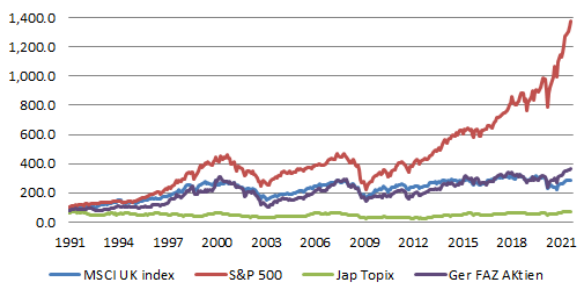
The recovery in the Far East is advanced and we have reduced our portfolio weightings here, while expecting Europe and the US to be engines of recovery in the medium term. That said, our higher risk portfolios include Indian equities, which we expect to benefit as companies diversify from China. Developed government bonds pay very low returns and we are concerned that any bias to tighten monetary policy may lead to yield curves rising. Thus, we are focusing on corporate and high yield debt to counterbalance equity exposure.

Markets at a glance



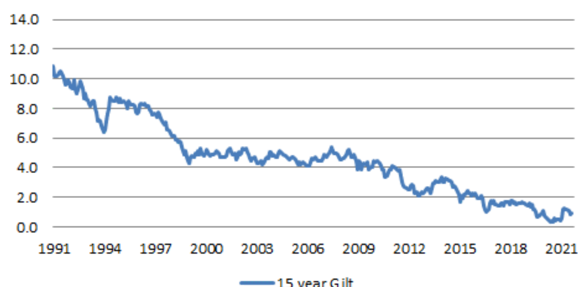
Source: Lipper for Investment Management

The UK equity market has become becalmed in recent weeks, with the FTSE 100 index trading around the 7,000 level. Despite a strong earnings and cashflow recovery from the lows of the COVID crisis, the signs of softening economic growth and rising inflation pressure with a risk that monetary policy may become less accommodative are concerning investors. The Bank of England seems to be in no hurry to tighten monetary conditions. However, these risks plus ever-present COVID risks are keeping the lid on domestic equity prices. The UK remains one of the cheapest valued developed equity markets.



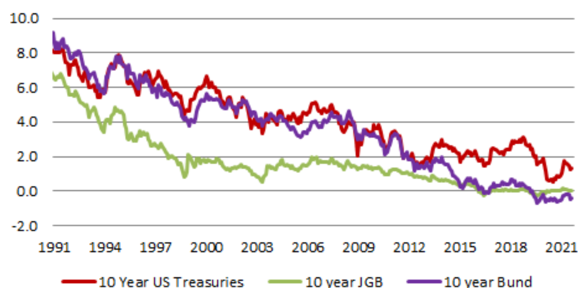
Source: Lipper for Investment Management

Global equity prices have also traded sideways recently, even as corporate earnings are recovering strongly in many countries. Europe and the US are leading the way in the year-to-date, as Japanese and Asian equities tread water. Global trade is addressing supply and shipping availability issues, which are leading to a moderation of growth expectations. If the world overcomes short term growth issues, we foresee further upside in prices. However, our forecasts assume that the major economies manage the coronavirus pandemic with a limited impact on activity, even as policymakers debate the inflationary consequences of their actions.



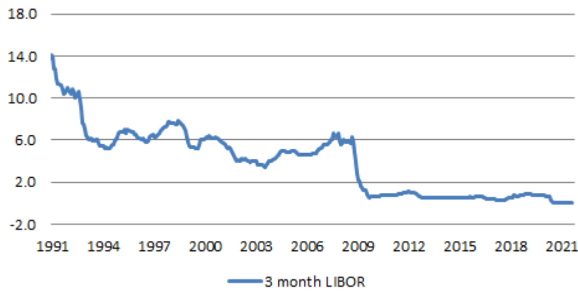
Source: Lipper for Investment Management

Gilt yields have risen by 25 basis points over the last two months – the 10-year gilt currently yields 0.80% to redemption. Inflation concerns reflect shortages of materials and wage pressures, given labour shortages in sectors, such as retail and hospitality. The low yields reflect extremely low official interest rates and more quantitative easing by the Bank of England, although policymakers are waiting and seeing on inflation risks. No near term interest rate intervention is foreseen. Furthermore, the Bank is now buying fewer gilts per week than are being issued, although we expect a further £250 billion expansion of QE to fund government expenditure. The gap between 5-year and 30-year borrowing costs remains near a two-year peak.



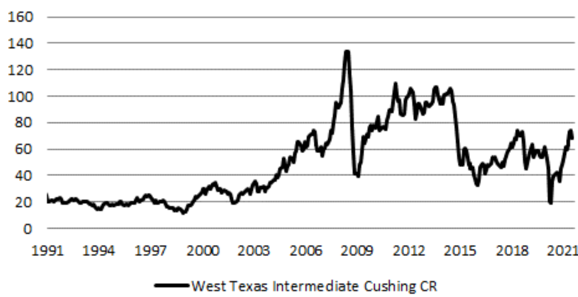
Source: Infront

Government bond yields have risen modestly across the US, Germany, and Japan. The latter has just turned into positive territory. Higher inflation risks and possible resultant policymakers remain concerns for investors, although policymakers are choosing their language carefully, so as to not encourage markets to expect actions too soon. We expect the levels of quantitative easing to fall through the remainder of this year and no changes in interest rates across the developed economies. This is despite a number of emerging market central banks raising their domestic rates. We believe that monetary policy will remain loose and yields will remain low into 2022, although longer dated yields may rise.



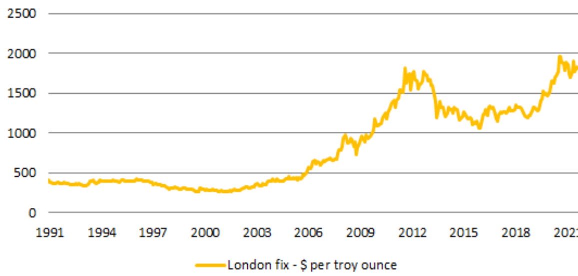
Source: Lipper for Investment Management

The Bank of England is warning of a more pronounced period of above-target inflation in the near term. The Bank's main lending rate remains at a historic low of 0.1%, where it has been since March 2020. The quantitative easing program remains at £895 billion. The central bank has raised its inflation forecasts to 4% in 2021 Q4 and 2022 Q1, following two consecutive months of above-forecast readings. The temporary rise in the consumer price index is primarily due to rising energy and other goods prices, which are set to moderate in the medium term to bring inflation back toward its 2% target. We expect short-term rates to remain near historic lows, as we doubt the Bank Rate will be raised above the current level any time soon.



Source: Lipper for Investment Management

Brent crude oil spot prices averaged $71/barrel in August, down $4/barrel from July but up $26/barrel from August 2020. Rises over the past year have resulted from steady draws on global oil inventories, which averaged 1.8 million barrels per day during the first half of 2021. We expect Brent prices will remain near current levels for the remainder of this year, averaging $71/b during the fourth quarter. In 2022, we expect that growth in production from OPEC+, US light oil and other non-OPEC countries will outpace slowing growth in global oil consumption and contribute to Brent prices declining to an annual average of $66/b.



Source: Lipper for Investment Management

Amidst uncertainties about economic growth and the next interest rate hike, gold prices are a little below their all-time highs, set last summer. In the short to medium term, it appears as if gold demand will continue to be driven by central bank policy, which should remain accommodative, even as inflation fears increase. The physical market for gold remains weak. Despite a rebound in India's gold imports, China's gold imports are very low. The key to any rally in the gold price will be investor concerns about global inflation risks. This real asset presents a store of value in inflationary times, as witnessed by a modest rally from early year price lows.

Note that where an MSCI Index has been used for illustration. This has been sourced with permission from MSCI Inc.

Quick facts

ISA Allowance 2021/2022	Stocks & Shares ISA Cash ISA Junior ISA	£20,000 £20,000 £9,000
Pension Allowance 2021/2022	The limit is the greater of £3,600 and 100% of salary, subject to the annual allowance of £40,000 (unless money has been accessed through flexi drawdown in which case the annual allowance is limited to £4,000).	

Tax facts

Income Tax	Personal Allowance 2021/2022	Up to £12,570
	Basic Rate @ 20%	£12,571 to £50,270
	Higher Rate @ 40%	£50,271 to £150,000
	Additional Rate @ 45%	Over £150,000
	Married couple's allowance:	Minimum £3,530
	Older spouse born before 6 April 1935	Maximum £9,125
		Up to 10% of the appropiate Min/Max
Capital Gains Tax	Annual Exemption - Individuals	£12,300
	Basic Rate tax band (residential property)	18%
	Basic Rate tax band (other assets)	10%
	Higher Rate tax band (residential property)	28%
	Higher Rate tax band (other assets)	20%
	Business Asset Disposal Relief	10%
	Business Asset Disposal Relief limit of gains	£1,000,000
Inheritance Tax	Threshold up to £325,000	Nil
	Over £325,000	40%
Corporation Tax	Full Rate	19%
	Small Companies Rate (SCR)	19%

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