



MORNING BRIEFING

September 21, 2021

Too Grande To Fail?

Check out the accompanying [chart collection](#).

(1) China's Evergrande panic attack hits global stock markets. (2) Crash course in Evergrande. (3) "Massive" describes its scale, debt, and crisis. (4) Will its rescue also be massive? (5) Lehman or LTCM? (6) China should be building more nursing homes than apartment buildings. (7) Betting against a credit crunch. (8) Bullish for the dollar, bearish for commodity prices.

China I: Buy on the Drop? Joe and I might have to start a panic attack list for the China MSCI stock price index like the one we've been keeping for the S&P 500 stock price index since 2009. We are up to 69 panic attacks in the S&P 500. (See our [S&P 500 Panic Attacks Since 2009](#).)

Since 2009, there have been several selloffs in the China MSCI stock price index ([Fig. 1](#)). They tended to coincide with the selloffs in the S&P 500, suggesting that most of them weren't homegrown and were caused by the jitters in the US stock market ([Fig. 2](#)).

However, the selloff in China's MSCI during 2018 was attributable to mounting trade tensions between the US and China. The selloff in early 2020 was triggered by the pandemic lockdowns that the Chinese government imposed during January and February of that year. The selloff in recent weeks has been caused by numerous regulations imposed on high-tech companies in China by the government. The drop in China's MSCI in recent days has been caused by the looming collapse of Evergrande. This index peaked at a record high on February 17 and is down 29.4% since then through Friday's close. China's stock markets are closed for their mid-Autumn festival, so the China MSCI index will likely fall even further when trading begins on Wednesday.

As we all have learned very quickly in recent days, Evergrande is a huge property developer in China. Here are the gory details of Evergrande's rise and fall, some of which Jackie and I reviewed last Thursday:

(1) *Massive scale*. Evergrande until recently was China's second-largest property developer, with \$110 billion in sales last year. It has \$355 billion of assets across 1,300

developments, many located in China's lower-tier cities. Evergrande has 200,000 employees and hires 3.8 million workers every year for project developments. Evergrande has 800 residential buildings across China that are unfinished, leaving as many as 1.2 million people not knowing when or if they will be able to move into their new homes.

(2) *Massive debt.* The company's liabilities exceed \$300 billion and are owed to more than 128 banks and more than 121 non-bank institutions. Evergrande is one of the largest bond issuers in the emerging markets, with \$20 billion of debt outstanding.

Evergrande raised funds in the shadow banking market via trusts, wealth management products, and commercial paper. About 40 billion yuan, or roughly \$6 billion, of the wealth management products have matured, and the company has not paid investors. An Evergrande executive said that more than 70,000 people across China have bought the company's wealth management products. Many of the investors are Evergrande workers because the company encouraged staff to purchase the investments.

Yesterday, *The New York Times* [reported](#): "When the troubled Chinese property giant Evergrande was starved for cash earlier this year, it turned to its own employees with a strong-arm pitch: Those who wanted to keep their bonuses would have to give Evergrande a short-term loan."

(3) *Massive crisis.* Evergrande is facing a liquidity crisis. In what's never a good sign, the firm hired two restructuring shops—Houlihan Lokey (China) and Admiralty Harbour Capital—and retail investors in Evergrande's wealth management products showed up at headquarters to demand their money back. On Friday, Chinese junk-bond yields jumped to an 18-month high, and shares of real estate companies plunged after Evergrande had its credit rating downgraded and requested a trading halt in its onshore bonds. Evergrande's main banks were told by China's housing ministry last week that the developer won't be able to make interest payments due September 20, which was yesterday.

(4) *Massive save?* We believe that Evergrande is too big to fail. Yesterday, we observed: "The financial press has been suggesting that the collapse of China's second-largest property developer could cause shock waves similar to Lehman's bankruptcy in 2008. We think the collapse of Long-Term Capital Management (LTCM) in 1998 is a better analogy. We expect that the Chinese government will restructure Evergrande, probably by splitting up its businesses among other property developers."

Lehman was allowed to fail by the US Treasury and the Fed. (See [Appendix 4](#) of my book

Fed Watching For Fun and Profit.) They could have chosen to bail it out but didn't. US government officials should have known better but didn't. Lehman had sold lots of credit derivative products around the world. The resulting financial crisis confirmed that Lehman was too big to fail. LTCM was restructured by the Fed with the help of the major banks in the US. Lehman turned a garden-variety bear market in the stock market into a ferocious bear market. LTCM triggered a garden-variety correction.

Chinese government officials are well aware of the headlines comparing Evergrande to Lehman. They are well aware of the consequences of letting the firm fail. So they'll intervene to restructure it. When, they do, stock markets around the world should enjoy relief rallies.

China II: Structural Problems. China's property developers have been a very important source of economic growth and employment in China. The Chinese government needs all the growth it can get out of the property sector and export markets because China's consumer spending has been slowing dramatically as a result of its rapidly aging demographic profile.

Inflation-adjusted retail sales in China may be the most important variable for tracking the increasingly dismal economic impacts of China's aging demographics. Every month, the Chinese report nominal retail sales and the CPI, which we use to calculate real retail sales. We've been monitoring the yearly percent change in this series for the past few years ([Fig. 3](#)). To smooth out the impact of the pandemic on this series, Mali and I calculate the 24-month growth rate in the 24-month average of the series ([Fig. 4](#)). The result must be downright alarming for the Chinese government. At an annual rate, this growth rate peaked at a record high of 18.7% during May 2011. It has been trending down since then, falling to almost zero during August of this year!

We've been monitoring this series for some time as an indicator of how China's rapidly aging population might weigh on the country's economic growth. The legacy of China's disastrous one-child policy, which was imposed from 1979 through 2015, has frustrated the government's efforts to transform the Chinese economy from export-led growth to consumer-led growth. The ongoing strength in China's exports explains why industrial production growth, calculated on the same basis as real retail sales, remains relatively strong around 5%—though that too is down significantly from a peak of 15.0% during March 2012 ([Fig. 5](#)).

Perhaps China needs to be building more nursing homes and fewer apartment buildings.

China III: Credit Crunch Unlikely. From what we can gather, we don't expect Evergrande's troubles to cause either a domestic or global credit crunch. To put its \$300 billion debt into perspective, consider that Chinese bank loans have increased from about \$5 trillion during 2008 to about \$30 trillion now ([Fig. 6](#)). Chinese social financing totaled \$4.7 trillion over the past 12 months through August ([Fig. 7](#)). That sum includes \$3.1 trillion in bank loans ([Fig. 8](#)).

Chinese banks have been able to finance all of their lending with their deposits. M2 increased from around \$6 trillion during 2008 to \$36 trillion currently. Bank loans are currently 81.2% of M2, a record high, but have never come close to 100% of M2 ([Fig. 9](#)).

So we don't expect a credit crunch in China. We do expect that the People's Bank of China (PBOC) will inject more liquidity into the financial system. While the Fed, ECB, and BOJ all are talking about tapering, the PBOC is expected to ease credit conditions in response to the slowing of China's economy as a result of high raw material costs, new Covid-19 outbreaks, floods, and now Evergrande.

The PBOC delivered a surprise cut in bank reserve requirements in July ([Fig. 10](#)). Another one is likely before the end of this year. In mid-August, the PBOC also injected billions of yuan through medium-term lending facility (a.k.a. MLF) loans into the financial system.

China IV: Global Repercussions. At this time, the major global impact of the Evergrande crisis is likely to be on foreign exchange and commodity markets. The trade-weighted dollar bottomed this year on June 1 and rose 2.6% through Friday's close and is likely to move higher now ([Fig. 11](#)). The trade-weighted dollar tends to be highly inversely correlated with the Goldman-Sachs commodity index (S&P GSCI). This index has been looking topky in recent weeks.

Among the commodity prices that are most sensitive to economic activity in China is the price of copper. More often than not, the China MSCI stock price index (in yuan) closely tracks the price of copper ([Fig. 12](#)). As noted above, the China MSCI is down 29.4% from its record high on February 17 through Friday's close. Copper has been looking topky in recent weeks, and now is likely to move lower.

Calendars

US: Tues: Housing Starts & Building Permits 1.56mu/1.60mu, Current Account Deficit - \$191.2b, API Weekly Crude Oil Inventories. **Wed:** Existing Home Sales 5.98mu, MBA Mortgage Applications, Crude Oil Inventories, Fed Interest Rate Decision, FOMC Economic Projections. (Bloomberg estimates)

Global: Tues: UK CBI Industrial Trend Orders 16, BOJ Interest Rate Decision, PBOC Loan Prime Rate, Bullock. **Wed:** Eurozone Consumer Confidence -5.8, Wuermeling, Mauderer, Woods. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings ([link](#)): All three of these had forward earnings at a record high last week. LargeCap's was at a record high for a fourth week after being out briefly in early August following Amazon's negative earnings guidance. MidCap's was at a record high for a 32nd straight week, and SmallCap's was at a record for a second week after dropping a week earlier for the first time in 26 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 68 of the past 70 weeks, with the two down weeks due to Tesla's addition to the index last December and Amazon's earnings shortfall in August. MidCap's is up in 66 of the past 68 weeks, and SmallCap's posted 65 gains in the past 69 weeks. Forward earnings for these indexes had been on an uptrend from November 2019 until February 2020, before tumbling to a bottom by June 2020 due to the Covid-19 economic shutdown. LargeCap's forward earnings has risen 52.3% from its lowest level since August 2017; MidCap's is now up 98.4% from its lowest level since May 2015; and SmallCap's has soared 156.3% from its lowest point since August 2013. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings was 36.9%, down from a record-high 42.2% at the end of July. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings fell w/w to 65.3% y/y from 66.4%. That's down from a record high of 78.8% at the end of May and up from a record low of -32.7% in May 2020. SmallCap's rate dropped to 96.7% from 98.8%; it's down from a record high of 124.2% in late June and up from a record low of -41.5% in June 2020. Companies have been beating consensus estimates quite handily since the Q2-2020 earnings season,

causing analysts' y/y earnings growth forecasts for 2021 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (44.0%, 9.6%), MidCap (74.4, 6.6), and SmallCap (112.4, 13.6).

S&P 500/400/600 Valuation ([link](#)): Valuations mostly ticked lower last week for these three indexes. LargeCap's forward P/E dropped 0.2pt w/w to an 11-month low of 20.6. LargeCap's forward P/E compares to a 19-year high of 22.7 in early January and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's fell 0.1pt to a 17-month low of 16.3. That compares to a seven-month high of 20.5 in early March and is 6.5pts below its record high of 22.9 in June 2020. SmallCap's remained steady at a 17-month low of 15.4. It's now down 11.3pts from its record high of 26.7 in early June 2020. During March 2020, MidCap's 10.7 and SmallCap's 11.1 were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for a 50th week. That's the longest stretch at a discount since 2002-03; SmallCap's current 25% reading is near its biggest since 2001. SmallCap's P/E had been mostly above LargeCap's since 2003. Looking at SmallCap's P/E relative to MidCap's, it was at a discount for a 14th straight week; SmallCap's current 5% discount to MidCap's is near its biggest since 2003.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Since the Q2-2020 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. Those gains have endured even through the earnings warnings season, when forecasts typically decline. In the latest week, the S&P 500's Q3-2021 blended earnings-per-share estimate ticked down 7 cents w/w to \$49.14. That \$49.14 estimate for Q2-2021 represents a gain of 27.0% y/y on a frozen actual basis and a 29.5% y/y gain on a pro forma basis. That would mark a third straight quarter of double-digit percentage growth and compares to a pro forma gain of 95.6% in Q2-2021. All 11 sectors are again expected to post positive y/y earnings growth during Q3-2021. Here are the S&P 500 sectors' latest expected earnings growth rates for Q3-2021 versus their final Q2-2021 growth rates: Energy (1,437.6% in Q3-2021 versus 244.4% in Q2-2021), Materials (93.8, 139.2), Industrials (83.0, 698.1), S&P 500 (29.5, 95.5), Information Technology (28.5, 49.5), Communication Services (23.9, 73.1), Financials (18.0, 156.6), Real Estate (17.6, 38.8),

Health Care (14.2, 26.4), Consumer Discretionary (9.3, 368.0), Consumer Staples (2.5, 20.4), and Utilities (0.4, 12.7).

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