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Market views and strategy

Ostrum
ASSET MANAGEMENT

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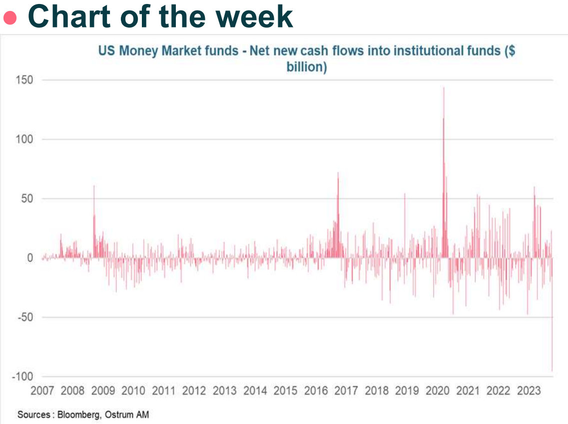
Topic of the week: China's Real Estate Crisis: "an air of déjà vu"?...

- **The Chinese real estate crisis bears similarities with the Asian crisis of 1997, particularly on the over-investment in sectors that are unsustainable over the long term;**
- **Nevertheless, financial risk remains focused on real estate through local governments and their financing vehicles (LGFV);**
- **LGFV collossal debt is a risk for the Chinese banking sector;**
- **Recent government measures, including LGFV debt restructuring, should best stabilize the sector;**
- **China needs new growth drivers, which is challenging in this hostile international environment.**

Market review: Powell's guilty hesitations

- **Fed: a pause is likely in November despite sustained growth;**
- **Strong tensions on T-note yields which skirts 5%;**
- **Risky assets under pressure from high yields;**
- **Gold is back as a safe haven.**

Chart of the week



US money market funds have seen unprecedented redemptions over the past seven days. According to ICI data, outflows reached $95 billion between Thursday October 12 and Wednesday October 18.

In addition to arbitrage towards bonds as yields rise, the main reason for these movements seems to be corporate tax payments (usually mid-September) postponed by a few weeks due to climatic disasters recorded at the start of year.

Figure of the week

21.2

Source : Bloomberg

China sold $21.2 billion worth of American assets in August (including $15 billion in bonds), the biggest drop in 4 years. This comes as the PBoC attempts to stem the depreciation of the yuan against the dollar.

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●Topic of the week

China's real estate crisis: "an air of déjà vu ? »…

The 1997 Japanese financial crisis was the defining event of Modern History. The setbacks of Chinese property developers have raised the spectre of the Japanese crisis that had precipitated the Japanese economy into a long period of stagnation. Is the same fate awaiting China? To answer this question, we propose a focus on the Chinese real estate sector and its links between the different actors.

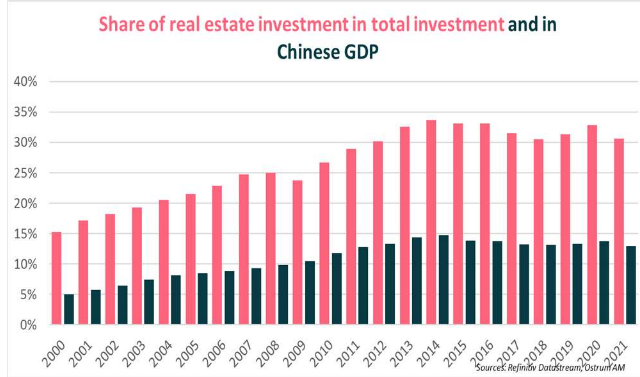
Financial risk is focused on the real estate sector…

Similarities with the 1997 Asian crisis: over-investment

The Chinese housing crisis bears similarities with the Asian crisis of 1997. Asian countries had experienced rapid growth based on investment. The investment rate exceeded 30% of GDP, even 40% for some countries. However, most investments went to sectors that were not viable and sustainable in the long term such as real estate and infrastructure projects. This had created overcapacity in several sectors, contributing to bubbles on financial and real estate assets precipitating the financial crisis.

The rapid growth of real estate investment…

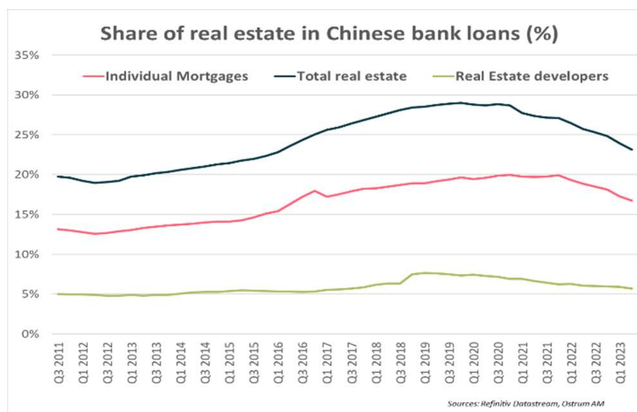
China has also experienced extraordinary growth in recent decades based on investment. This represents 40% of GDP, of which 1/3 is real estate investment, as shown in the graph below.



Real estate has important ramifications for the Chinese economy. It represents ¼ of GDP and 20% of employment. Its share rose from 5% of GDP in 2000 to 13% of GDP in 2019.

… Particularly in the banking sector

Chinese commercial banks and local government financing vehicles quickly took exposures to the real estate sector. Between 2011 and the end of 2021, the share of loans granted to the real estate sector in total bank loans increased from 20% to 27% at the end of 2021, as shown in the graph below.



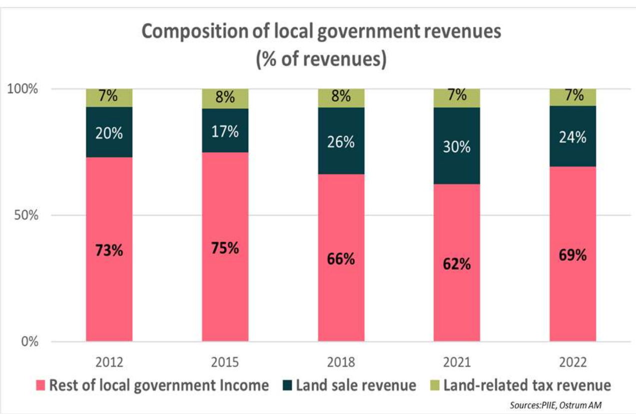
The risk for Chinese commercial banks does not lie in mortgages taken out by households. Indeed, capital requirements when buying real estate are high in China, at 30% for first-time buyers and even higher for other buyers in most cities.

On the other hand, the quality of loans from developers has deteriorated in recent years due to tighter financial restrictions within the "common prosperity" paradigm. The latter account for only 5.7% of total bank loans.

… Through Local Governments …

The Chinese authorities have always relied on local governments to boost growth by supporting infrastructure investment. They have played an important role in the rise of real estate by providing major sources of income.

Local governments generate income from land through two channels: land use rights sale and property tax.
The first channel allows local governments to “lease” land to purchasers who have the right to use and benefit from it, while the central government retains ownership. The sharp rise in land prices over the past two decades, coupled with the rapid growth of the real estate sector, had allowed local governments to sustain their spending. The chart below shows the composition of local government revenues over the period 2012-2022.

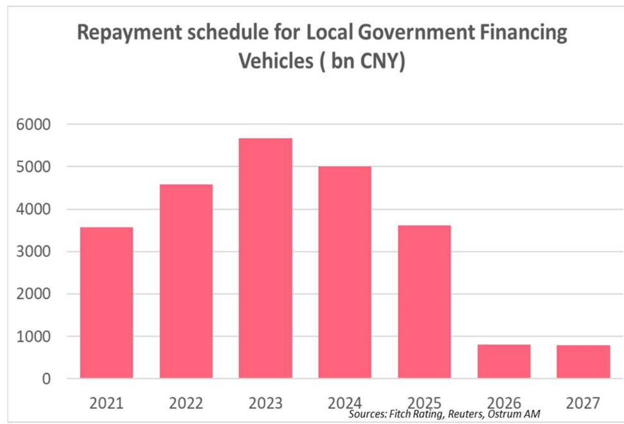


The share of land sales in local government revenues increased over the period from 20% in 2012 to 30% in 2021. In 2022, financial restrictions on Chinese property developers, caused significant defaults.
Revenues from land sales fell in 2022, accounting for only 24% of local government revenues, as local governors struggled to sell the land. The fall in local government revenues has weakened them because they are heavily indebted. Their debt reached 92 trillion yuan ($12.6 billion), or 76% of China’s GDP, up 14 ppt from 2019.

…Including the Local Government Financing Vehicles…

A portion of the local government debt was issued through financing vehicles (LGFV), the funds thud raised were used to finance infrastructure projects. The evolution of local governors within the Chinese Communist Party depends on their ability to generate growth, in which the real estate sector has gained significant weight. LGFV were used to bridge the gap between government expenditures and revenues.

According to, the International Monetary Fund, their debt has reached a record of $9,500 billion, or half of China’s GDP! LGFV will also face a debt wall. Thus, CNY5.6 trillion of debt, or $790 billion, will mature this year, as shown in the chart below.



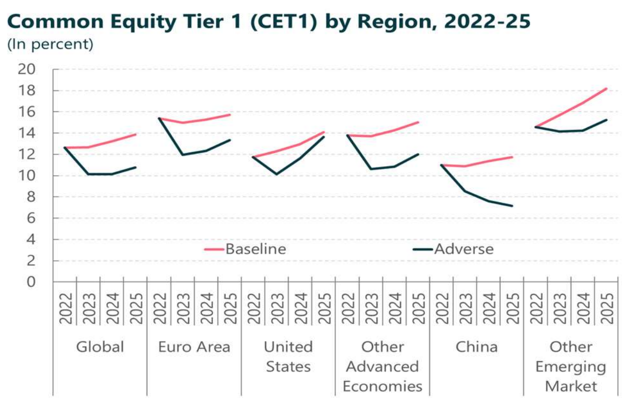
Significant repayment amounts are also expected in 2024, amounting to CNY5.5 trillion.
No LGVF has failed so far. However, the current housing crisis in China has put pressure on their ability to repay, as their income depends closely on the sales of land and real estate.

According to the IMF, 30% of LGFV would be unsustainable without central government financial support.
Chinese real estate developers have also used financing vehicles, trust companies, to finance themselves. According to the China Trustee Association, the total amount of loans from trust companies to the real estate sector is about CNY2 trillion. For example, trust companies represent 40% of the financing of real estate developer Evergrande.

… A big problem for banks…

The difficulties of LGFV to repay their debts, pose a real risk to Chinese commercial banks who hold 80% of their debt. According to the IMF, only half of the debt restructuring costs of financing vehicles would impose depreciation charges of $465 billion, which would reduce by 1,7 percentage point the ratio of loss-absorbing capital to assets.

In its October Report on Global Financial Stability, the IMF stress tested the levels of banks' capital ratios for several areas in several scenarios, over the period 2022-2025. Under the adverse scenario, based on assumptions of 1% Chinese GDP growth (instead of 5%) over the next 3 years in a context of continued decline in the value of real estate, the capital ratio of Chinese banks will fall to 7,5% in 2025, the worst level among the different areas as shown in the chart below.



Sources: IMF, Global Financial Stability, Ostrum AM

A doom loop can also emerge. Bank losses should encourage banks to restrain credit. Local governments unable to borrow will cut investment and social services, further weakening Chinese growth.

What crisis for China ?

Notable differences from the 1997 Asian crisis

The prospect of a Chinese financial crisis identical to the 1997 financial crisis is unlikely, as the debt is held by domestic investors and not foreign investors. On the contrary, China has become the world's largest creditor, especially for poor countries. On the other hand, the Chinese authorities have not opened their capital account by maintaining a policy of exchange control, which allows it to be protected from sudden outflows of capital that can lead to financial instability.

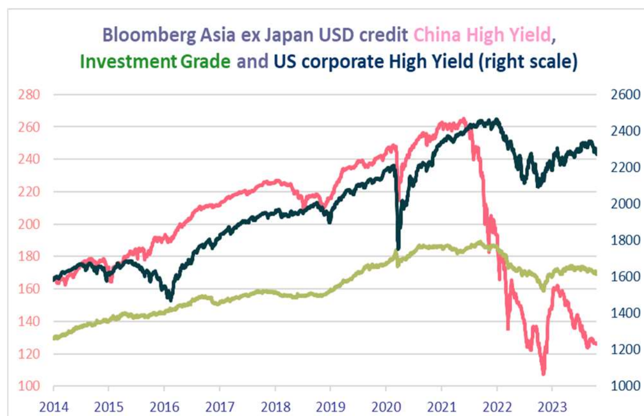
In addition, Chinese commercial banks are controlled by the state or local governments that should not let them fail, which has allowed China to avoid episodes of "bank runs" and banking panics.

Moral hazard and the reconstitution of risk premiums

Local governments were able to borrow heavily because there was this implicit guarantee that the State would intervene to bail them out.

That is exactly what happened in the real estate sector. Because of its important weight in the Chinese economy, there was also this implicit guarantee that the Chinese state would continue to support the real estate sector. However, in 2022, under the new paradigm of common prosperity, the tightening of financial restrictions on real estate developers was a turning point in the perception of Chinese real estate risk.

The bankruptcy of Evergrande showed that the state would not intervene to bail out developers. Risk premiums then rapidly recovered, leading to the fall of financial assets related to the real estate sector, such as the Bloomberg China high yield credit index fell by more than 50% since its April 2021 high point, as shown in the chart below.



The latter, after an attempt to rebound at the beginning of the year probably linked to high expectations on Chinese growth, The risk is more focused on a reconstitution of risk premiums on banks and local governments, weakening the country's financial stability.

The Chinese authorities are aware of the risk and have taken a series of measures to try to restructure the debt of the LGFV as well as allow the property developers to complete their projects. The recent measures announced should help stabilize the real estate sector at best but will not solve the problem of Chinese growth.

Conclusion: China's economy needs new growth engines

Given the massive size of the debt, and the weakness of Chinese growth, the risk of a rapid rise in default rates is high. The Chinese authorities will not be able to transfer all the risk to asset management companies as they did in the past during its first banking crisis. China's investment-based economic model has shown its limits. China must find other growth engines to prevent its housing crisis from turning into a serious financial crisis like that experienced by Japan in the 1990s.

Xi Jinping is rebalancing its economy towards consumption (by greening it), but it is struggling to materialize. Chinese consumption represents only 38% of GDP, far from the 70% for US consumption. While Q3 GDP has shown that Chinese growth is more balanced because it is driven by consumption, this trend must be sustainable over the long term.

The less buoyant international environment, notably due to US sanctions on its technology, has forced China to close in on itself by accelerating its refocusing on its domestic demand. This is particularly the case for the semiconductor industry where China's investment in this sector has intensified. The Dual circulation continues to be implemented to enable China to benefit from the services it needs for its economic growth. While the risk of financial contagion seems limited, the effects of a strong Chinese economic slowdown would have a major impact on the rest of the world.

Zouhoure Bousbih

Market review

Powell's guilty hesitations

The status quo on Fed funds seems to go against the trend of publications and risks increasing pressure on long rates and risky assets.

Two opposing forces are influencing long-term rates. The conflict in the Middle East with the risk of regional escalation is exerting a dampening force on the US 10-year bond yield. Conversely, sustained strong growth in the United States supported by a federal deficit of nearly 8% of GDP induces upward pressure on long-term yields. In this context, one can regret the somewhat contradictory stance of Jerome Powell who struggles to justify the pause which is taking shape during the FOMC on November 1st. The T-note yield skirts the 5% threshold. As for the Bund, yields hover around 2.90%. Gilt (4.67%) also sold off. Sovereign spreads in the euro area are stabilizing pending decisions by the rating agencies on France (62 bp at 10 years) and Italy (203 bp). Breakeven inflation rates (+14 bp) explain almost half of the weekly increase (+32 bp) in the 10-year US yield. Nervousness in the oil market is fueling inflation expectations. The easing of swap spreads does not benefit credit, which is now trading above 100 bp against swap. Demand for credit risk coverage takes the iTraxx XO above 470 bp. At the same time, tensions on rates are weighing on stock market valuations. Dividend and value themes outperform quality and growth. Emerging debt in dollars widened modestly by 5 bp. The dollar remains strong in the absence of a competing safe haven, with the exception of gold which is approaching $2,000.

The Fed's communication is ambiguous. Jerome Powell's last speech before the FOMC generated volatility in rates as the announced pause seems to go against the strength in recent publications. So far, monetary tightening has not slowed growth, quite the contrary, but the Fed believes that rate increases will ultimately weigh on aggregate demand. The Fed will take time to observe the impact of the rise in long-term rates, particularly on credit supply. Commercial real estate loans have indeed been flat for several weeks. Furthermore, the ECB meets this week. If there is now consensus on a prolonged status quo on rates, the question of PEPP reinvestments will be debated as surveys have been weakening since the summer in the euro area. Chinese growth improved in the 3rd quarter (+1.3%) thanks to the rebound in consumption. The improvement is modest given the downward revisions to the 2nd quarter GDP (+0.5%) and the persistent weakness of real estate.

The Treasuries market remains bearish. Ten-year yields touched 4.99% last week and the latest issues reflect reduced demand for long-term bonds, whose issue sizes are expected to be further increased. In addition to the next FOMC, the quarterly Treasury refinancing in early November could be the catalyst for a further yield increase. The steepening of the curves is also observed in Europe. The Bund is holding up at around 2.90%, as the public deficit outlook remains contained in Germany. The 10-year swap spread is at 60 bp. The issue of public finances is coming back to the forefront. The restoration of fiscal deficit rules in 2024 puts renewed pressure on France and Italy, subject to the risk of deterioration of their ratings. Portugal (71 bp) and Greece (146 bp) outperform.

Credit spreads are being delayed by the widening of CDS indices. European IG (161 bp against Bund) differs by 4 bp over one week. The primary market offers new issue premiums of 15-20 bps but investor allocations are variable and subsequent performance uncertain. High yield is still subject to regular fund outflows, but the slim primary market activity limits the upward pressure on spreads. However, euro high yield (482 bp against the Bund) widened by 18 bp over five trading sessions.

Equity markets are suffering from the sharp rise in long-term bond yields and the deleterious international environment. The S&P 500 lost 1.6% The earnings season has started in the United States. The proportion of upside surprises is in line with the average of 75%. On the first 80 earnings publications of the S&P 500, profit growth stands at 2.2% over one year compared to 5.7% for sales, which indicates some deterioration in margins in certain sectors.

Axel Botte

Main market indicators

G4 Government Bonds	23-Oct-23	1wk (bp)	1m (bp)	2023 (bp)
EUR Bunds 2y	3.15%	-1	-11	+38
EUR Bunds 10y	2.94%	+16	+20	+37
EUR Bunds 2s10s	-20.8bp	+17	+32	0
USD Treasuries 2y	5.12%	+2	+1	+69
USD Treasuries 10y	4.99%	+28	+56	+112
USD Treasuries 2s10s	-13bp	+27	+55	+43
GBP Gilt 10y	4.7%	+22	+45	+103
JPY JGB 10y	0.88%	+12	+1	-13
€ Sovereign Spreads (10y)	**23-Oct-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
France	62bp	0	+6	+7
Italy	200bp	+2	+6	-14
Spain	110bp	-2	+0	+1
Inflation Break-evens (10y)	**23-Oct-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR 10y Inflation Swap	2.55%	+5	-5	+0
USD 10y Inflation Swap	2.72%	+8	+9	+20
GBP 10y Inflation Swap	3.92%	+3	-8	+0
EUR Credit Indices	**23-Oct-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
EUR Corporate Credit OAS	165bp	+4	+18	-2
EUR Agencies OAS	80bp	-2	+8	+1
EUR Securitized - Covered OAS	89bp	-1	+9	+5
EUR Pan-European High Yield OAS	494bp	+23	+68	-18
EUR/USD CDS Indices 5y	**23-Oct-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
iTraxx IG	90bp	+6	+12	-1
iTraxx Crossover	474bp	+28	+55	+0
CDX IG	82bp	+6	+9	0
CDX High Yield	528bp	+36	+80	+44
Emerging Markets	**23-Oct-23**	**1wk (bp)**	**1m (bp)**	**2023 (bp)**
JPM EMBI Global Div. Spread	454bp	+3	+42	+2
Currencies	**23-Oct-23**	**1wk (%)**	**1m (%)**	**2023 (%)**
EUR/USD	$1.060	0.369	0.057	-1.0
GBP/USD	$1.217	-0.426	-0.377	0.7
USD/JPY	JPY 150	-0.287	-0.707	-12.6
Commodity Futures	**23-Oct-23**	**-1wk ($)**	**-1m ($)**	**2023 (%)**
Crude Brent	$91.9	$2.2	-$0.1	12.5
Gold	$1 978.7	$58.5	$62.8	8.5
Equity Market Indices	**23-Oct-23**	**-1wk (%)**	**-1m (%)**	**2023 (%)**
S&P 500	4 224	-2.39	-2.22	10.0
EuroStoxx 50	4 018	-3.17	-4.49	5.9
CAC 40	6 817	-2.93	-5.13	5.3
Nikkei 225	31 000	-2.08	-4.33	18.8
Shanghai Composite	2 939	-4.38	-6.17	-4.9
VIX - Implied Volatility Index	22.19	28.94	29.01	2.4

Source: Bloomberg, Ostrum AM

Additional notes

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