BARON CAPITAL

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Impact of Evergrande on China's Economy

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The economic situation in China continues to evolve. The most recent concerns that the Evergrande restructuring may trigger contagion to related sectors and markets raises the likelihood that local policymakers and officials will soon begin to act to contain such contagion and calm markets. However, it is also true that President Xi believes longer-term stability requires more market discipline with tighter regulatory guidelines and less government bailout. Thus, the playbook for this credit stress could prove less predictable, with more volatility, or a "lower v", in the v-shaped bottom that we anticipate.

We cannot predict when this will come or how forceful the initial messaging will be, but we are confident authorities have the wherewithal to restore order and confidence to markets. We further believe that Chinese equities have been in the process of discounting a credit and regulatory tightening for many months and view the related correction as well-advanced.

The high cost of property and home ownership is one of the 2 primary concerns of the middle class in China. Xi has laid out various reforms to contain property and land price appreciation in China, but this will represent a new direction and adjustment for a key economic sector, the related entrepreneurs, and most municipalities that historically have relied on land sales as a key component of fiscal revenue.

The most leveraged players, with Evergrande being the most levered, are feeling this adjustment now and we believe additional property developers are likely to incur some level of bond haircuts and equity loss. We believe the government's plan is to manage losses largely to the holders of speculative high-yield bonds and equity of the most leveraged players, while safeguarding at par the value of bank debt and liabilities while also supporting the market price/bids for underlying finished properties.

This will inflict discipline on those seen as engaged in too much speculation, leverage or growth, while maintaining stability for many developers with acceptable operating protocols, as well as the financial sectors. There will be some investment pools holding the high-yield bonds of Evergrande or others that will suffer mark to market losses, but the large majority of this will be borne by the relatively wealthy holders of "wealth management products", where the government has been warning for years that such products do not offer guaranteed returns. Losses here will also reduce moral hazard – an objective of the Party on the road to greater social, economic, and financial stability.

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