NOVUM
CAPITAL PARTNERS

Weekly Market Flash
Are China's actions desirable?

August 1, 2021

China was in the international spotlight this week. Following the crackdown on Didi immediately after its IPO in the US, a lot of pain has returned to investors this week. The collapse of real estate developer Evergrande's bonds was followed by the collapse of China's education stocks, as well as the increased regulatory pressure on internet companies. Following the rout in 2015, when Chinese authorities imposed restrictions on margin lending to reduce stock speculation, and a change in RMB management took place leading to fears of devaluation and the threat of a global deflationary wave, the actions of recent weeks are yet another sign that the Chinese system is anything but a capitalist market economy.

Highlights

- China will continue to allow Chinese companies to list on Wall Street as long as the requirements are met. Institutions also reassured banks that further regulations aren't forthcoming.

- The FOMC decided to keep rates unchanged and maintain the current pace of purchases of Treasuries and MBS. Powell sought to dampen speculation about tapering by noting that there is still "some ground to make up" before easing support for the economy.

- S&P Global Ratings cut property company China Evergrande Group's credit rating deeper into junk, making it the third downgrade by a global firm in about a month. The developer's dollar bonds due 2025 extended declines to 42 cents, a record low.

- ARRC, the Federal Reserve-backed Alternative Reference Rates Committee's ratification of a term structure for SOFR, should allow bankers and borrowers to begin using the benchmarks as soon as September.

"All the actions undertaken, if seen with detachment and clarity, are entirely understandable, if not desirable, for the sustainability of an economic and social system."

Markets & Macro | Are China's actions desirable?

A varying investment approach to debt versus equity.
When it comes to China, we believe it is important to separate the plans from the solidity of the economic system and the performance of stock markets. All the actions undertaken, if seen with detachment and clarity, are entirely understandable, if not desirable, for the sustainability of an economic and social system. Limiting speculation and financial leverage in the construction sector to avoid property bubbles and make house prices affordable (such as in the Evergrande case), encouraging competition, favoring workers and consumers (in the case of Meituan, Ant and Tencent), cutting tutoring costs in the education system (it has emerged that in China demographic development is limited by the cost of studies for children and houses) are all themes that are mentioned in our own western world.

Our view: In fact, only a couple of months ago, China ran its once-in-a decade census which revealed an alarming demographic trend. China's population increased to 1.41 billion in 2020 compared with 1.4 billion a year earlier. The official figures showed the population grew just 5.4% from 1.34 billion in 2010 — the lowest rate of increase between censuses since the People's Republic of China began collecting data in 1953. China also has a problem of an aging population, as a result of the historical law of population development, which cannot be changed at all. The CCP Politburo announced back in May (just after the census) that couples could now have three children. As a result, there is a need to focus on the common prosperity, with accelerated regulation in sectors with important welfare implications. In other words, making school and tutoring fees, housing and healthcare more affordable.

Beijing's actions are aimed at tackling inequalities, addressing adverse demographics and achieving the Great Society promised by Xi. This includes a set of measures also motivated by the determination of the

CCP to preserve its legitimacy and avoid any social discontent. As we have seen in other episodes in the past, after imposing severe measures with the consequent 20%+ losses in major indices, Bejing stepped in to halt the carnage. On Wednesday evening, China's regulator met with executives from major investment banks in a meeting led by China Securities Regulatory Commission Vice Chairman Fang Xinghai, who said China will continue to allow Chinese companies to list on Wall Street as long as the requirements are met. Institutions also reassured banks that further regulations aren't forthcoming. At this point, should other negative externalities of their crackdown emerge in the coming weeks, particularly in the credit market, we would bet on targeted monetary and fiscal easing to support the economy (after the recent cut to the banks' reserve ratios).

"...should other negative externalities of their crackdown emerge in the coming weeks, particularly in the credit market, we would bet on targeted monetary and fiscal easing to support the economy..."

The western world has been witnessing these events in China with suspicion. After Chinese autorithies reassured to grant their corporates access to US capital markets, it was the SEC that stated it needs time to assess market and regulatory conditions before accepting new IPOs of Chinese corporates, reinforcing the idea that financial decoupling between the two areas is almost complete.

Tensions also resurfaced at the political level this week, after a meeting of top level foreign department officials. The US goal is to keep channels of communication open, but not to backtrack on open games on the Chinese side. "In an exchange with Chinese Foreign Minister Wang Yi and Deputy Foreign Minister Xie Feng, Deputy Secretary of State Wendy Sherman laid out Washington's many concerns about the crackdown campaigns in Hong Kong, Xinjiang and Tibet that Beijing is carrying out." Sherman said his administration welcomed the "strong competition" with China, but the Biden administration expects "the nation to understand that human rights is not just a domestic issue, but a global commitment they have made."
As investors have fully understood, there is little difference between Biden's current approach on China and that of his predecessor. In fact, in his first six months in power, Biden has sanctioned Chinese officials involved in the Hong Kong crackdown, placed export controls on some Chinese tech companies, and extended Trump-era measures to prevent US investment in Chinese military arms companies. For the moment, therefore, we are witnessing an ideological competition, in which it is difficult to know who the winner is.

In terms of investment decisions, on the one side, recent events strongly reinforce our stance for deploying most of our equity exposure into financial and legal systems where capital is protected, laws are certain and not retroactive, and state presence in the economy low. By this, we clearly refer to the US and to smaller markets like the UK, Switzerland or Australia. Europe itself is another underweight in our asset allocation, since presence of the state in most economies is too relevant, and regulation too stringent, harming competition and innovation.

"...a year ago, we decided to delegate part our safe haven portfolio allocation to Chinese government bonds denominated in RMB."

Instead, a totally different stance can be held in relation to fixed income assets, governatives in particular. In this space, we don't chase performance but rather repayment of capital and interest, so our investment rules are different. As we said previously, Chinese authorities are targeting the sustainability of their own system, with a very long-term approach and limiting financial excesses. This is exactly why, a year ago, we decided to delegate part our safe haven portfolio allocation to Chinese government bonds denominated in RMB. The stability of the currency and the slight decline in yields experienced this week gave strong support to our investment thesis.

This being said, we are also opportunistic investors, and are fully open to tactical trades. As we luckily had almost zero exposure to Chinese equities and therefore did not suffer from the selloff in such stocks, we decided to start building some minor positions in Chinese equities after the selloff reached fire-sale levels, with signs of capitulation emerging. The attempt by regulators to stabilize markets is another point in favor of our choice, while valuations constitute a fundamental support. As can be seen by Figure 1, the discount to US equivalents is extreme, and should offer a buffer of protection in case of renewed tension. In terms of sectors, we're buying old economy names, and not big techs, where business models have to be completely reviewed and there is no certainty of future profitability.

Figure 1: MSCI China vs. S&P 500

Source: Bloomberg, as at July 30, 2021.

"The attempt by regulators to stabilize markets is another point in favor of our choice, while valuations constitute a fundamental support."

Dovish Fed should support real-economy-related sectors.

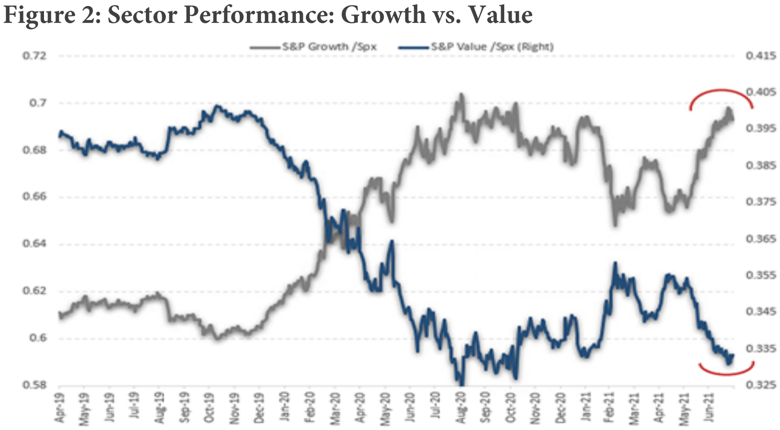
In US markets, the focus of the week was the FOMC meeting and press conference, which had a slightly dovish outcome. Fed Chair Powell communicated that the Committee decided to keep rates unchanged and maintain the current pace of purchases of Treasuries (USD80 billion/month) and MBS (USD40 billion/month). During the press conference, Powell nevertheless sought to dampen speculation about tapering by noting that there is still "some ground to make up" before easing support for the economy. At the same time, he acknowledged the "further progress" (not substantial, however) in the US economy despite the release of the Delta variant, and noted that the Committee would continue to monitor developments at future meetings. We have to add that recent indicators of the labor market (jobless claims and survey components) support caution in this regard.

Our view: We're introducing another change to our equity sectors allocation. As can be seen from Figure 2, growth sectors outperformance relative to value has reached quite extreme levels. As a result, we started adding to cyclicals, materials and energy in order to benefit from a mean reversion in equity flows.

"...we started adding to cyclicals, materials and energy in order to benefit from a mean reversion in equity flows."

Other elements have also underpinned this move. For example, the dovish Fed stance should allow the US dollar to resume its depreciation trend, thus supporting real-economy-related sectors. The US dollar also saw positioning clear recently with speculators being hit in June with excessive dollar shorts to cover. Moreover, the overcrowded reflation/reopening trade reached a climax in early June and has since disappointed, mainly due to the impact of the Delta variant. And Big tech results have failed to impress analysts and investors this week – albeit they are still fantastic – with Amazon and Facebook falling by 7% and 4% after earnings announcement. This signaled that very high growth expectations are already priced in. The fall in sales estimated for Amazon can be taken as a sign that the online boom is slowing down as consumers revert to traveling and recreation activities. And finally, the Senate has approved a bipartisan agreement in principle on a USD550 billion infrastructure spending package, which is expected to be debated and voted on by next week (August 9 is a recess).

Figure 2: Sector Performance: Growth vs. Value



Source: Bloomberg, as at July 30, 2021.

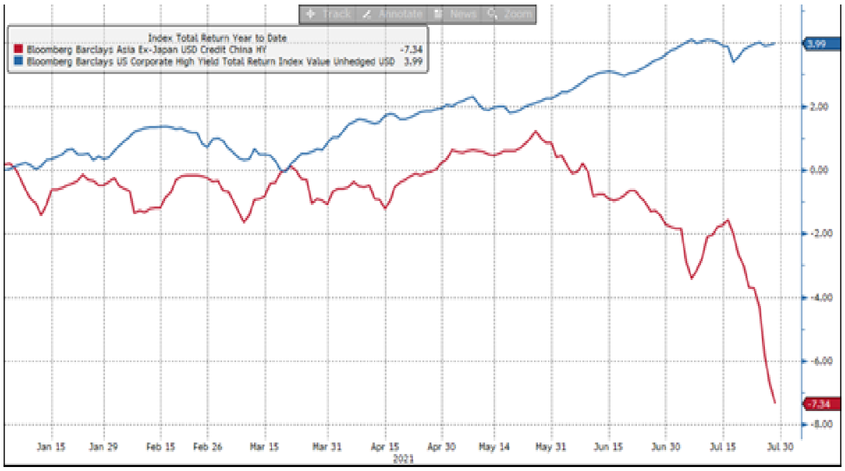
Fixed Income | Evergrande sees third global ratings downgrade

> "The past two months for high yield have been challenging due to idiosyncratic risks, tighter measures for China's property sector and the ongoing equity market selloff."

However, default is unlikely.

Credit distress in China is the most significant risk to global credit markets now, according to Bank of America Corp. That's because China is the second-largest US dollar corporate bond market in the world with USD425 billion in bonds outstanding, and the second-largest domicile of dollar high yield debt at USD103 billion.

Figure 3: China vs. US High Yield



Source: Bloomberg, as at July 30, 2021.

Our view: The past two months for high yield have been challenging due to idiosyncratic risks, tighter measures for China's property sector and the ongoing equity market selloff. One of the biggest concerns in China's credit markets now is property company China Evergrande Group. The world's most indebted developer – and Asia's biggest issuer of high yield dollar bonds – has struggled to reassure the market that it has ample ammunition to make good on its borrowings while also countering short-sellers. S&P Global Ratings cut the company's credit rating deeper into junk this week, making it the third downgrade by a global firm in about a month. The developer's dollar bonds due 2025 extended declines to 42 cents, a record low. A restructuring or default of Evergrande could generate a systemic event and lead to a cascade of defaults. As usual, in China a lot of this is heavily dependent on the government.

Our base case is not a default of Evergrande. However, increasing credit stress in China stemming from a government crackdown on a range of industries could spread to US investors' credit portfolios. Global high yield fund managers suffering losses in their Asia credit portfolios could look to lower risk across their holdings, or to sell more liquid, high-performing bonds such as US high yield. This selling pressure could weigh on valuations for the securities that are at record highs.

> "The shift would represent the missing step for the more than USD1 trillion leveraged loan market, because it should remove the operational challenges of moving from a forward-looking rate like Libor to an overnight rate such as SOFR."

Reference rate mismatch: interim risk for CLO equity investors.

ARRC, the Federal Reserve-backed Alternative Reference Rates Committee's ratification of a term structure for the Secured Overnight Financing Rate (SOFR), should allow bankers and borrowers to begin using the benchmarks as soon as September. The ARRC ratified term rates for 1, 3 and 6-month tenors based on the CME Group Inc.'s SOFR futures.

For both the borrowers and lenders it was essential to have a rate that is known in advance of the interest period. The shift would represent the missing step for the more than USD1 trillion leveraged loan market, because it should remove the operational challenges of moving from a forward-looking rate like Libor (1-month, 3-month, 6-month) to an overnight rate such as SOFR.

Our view: As a reminder, December 31, 2021 is the US banking regulators' deadline for ceasing the origination of new loans and CLOs referencing LIBOR. USD LIBOR for 1-week and 2-month will cease, while 3-month USD LIBOR is expected to exist until 2023. By June 30, 2023, remaining USD LIBOR settings cease or are no longer representative. Outstanding legacy contracts need to transition to replacement rates by this date at the latest.

“Such a reference rate mismatch will pose an interim risk for CLO equity investors, but it should not persist for a long time.”

Loans that fall back from LIBOR to SOFR will use the ARRC’s recommended spread adjustment set on March 5, 2021. The spread adjustments are fixed and won’t change. These spread adjustments will apply to loans as well as CLOs. As interests are so low today and SOFR and LIBOR are compressed, SOFR + spread adjustment is currently higher than spot LIBOR.

For CLOs, LIBOR fallback language typically includes the asset trigger, which allows CLO debt tranches to initiate the fallback if at least 50% of the underlying assets have switched to the alternative rate. On the other hand, loans usually have an “early opt-in” feature which essentially allows loans to initiate the transition process if at least five of new syndicated loans have a SOFR-based benchmark. Therefore, it is very likely that the underlying loans in a CLO portfolio will transition to SOFR earlier than CLO liabilities. In the current low-rate environment, current SOFR plus spread adjustment rate is higher than the 3-month LIBOR rate. Therefore, if CLO liabilities continue to pay in 3-month LIBOR while <50% of underlying assets have switched to SOFR, CLO equity cashflow could improve. Once 50% or more of the underlying assets have switched to SOFR, all CLO liabilities will switch to the SOFR rate. In this case, CLO equity cashflow will get hurt.

Such a reference rate mismatch will pose an interim risk for CLO equity investors, but it should not persist for a long time. In fact, Citi research has estimated the impact of a reference rate mismatch to be roughly 30 bps on quarterly CLO equity cashflow. And so far, only Ford Motor Co. has announced its intention to refinance its revolving credit facilities with SOFR.

Week Ahead | Key events to watch for

- **Next week will be busy in terms of data releases**, including the US labor market report on Friday. PMIs in Europe and the two ISM (manufacturing and services) indices will set the mood of investors at the beginning of the week.

- **In terms of central banks**, the Bank of England and three other central banks will gather during the weeks, where some action could be announced since rising inflationary pressures are becoming a global phenomenon.

- **150 US corporates will report** during the week, essentially closing the earnings season.

Vittorio Treichler
Chief Investment Officer

Flavio Testi
Senior Fixed Income Portfolio Manager

Daniele Seca
FX and Derivatives Portfolio Manager

Karim Khalil
Senior Equity Portfolio Manager