

Timely insights from portfolio managers and industry experts on key financial, economic and political issues.

The views expressed in these posts are those of the authors and are current only through the date stated. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance strategy. The discussion herein is general in nature and is provided for informational purposes only. There is no guarantee as to its accuracy or completeness.

FEBRUARY 10, 2022

[Emerging Markets Debt | Global Investing](#)

China Property: Evergrande May Just Be the Canary in the Coal Mine

Boston - What seemed like an isolated credit event for Evergrande has now sent shockwaves across China's real estate economy. We think international investors should keep a close eye for potential risks of contagion stemming from the Chinese housing sector to global financial markets.

Intended and Unintended Consequences

Even before the crisis, President Xi's hawkish remark in 2017 that "housing is for living, not for speculation" made sense. China's property sector is massive, even for a country of 1.4 billion people, and was responsible for a significant share of the country's GDP compared to most other economies. China has an estimated 500 million households and annual housing sales amounting to 1.5 billion square meters.

However, we believe these statistics greatly exceed the underlying housing demand by approximately 30%. A combination of easy credit and stable home prices, and a lack of investment alternatives elsewhere, led to years of excess housing demand beyond annual household formation.

Onshore banks were the first to answer Beijing's call. Major policy banks began reducing real estate exposure, tightening mortgage availability and increasing borrowing costs, particularly for buyers with existing homes. Every rung of the government from the Ministry of Finance to local municipalities followed suit: Down payment requirements for new purchases went up, and new property taxes would make it financially onerous to own property. The government's intent was clear.

China implemented the *Three Red Lines* policy in 2020, giving regulators and investors a fresh set of tools to rank developers by credit quality. Although Evergrande had a reputation for the liberal use of its balance sheet, its total liabilities were seldom scrutinized by the outside world. With the Three Red Lines, Evergrande's liabilities became a conspicuous concern for regulators, creditors and homebuyers.

As news broke that Evergrande was not delivering homes and not paying suppliers on time, the real estate sector took an abrupt turn in the second half of 2021, despite record presales in the first half. It did not take long for investors and homebuyers to point out other developers that, like Evergrande, failed or barely passed the Three Red Lines test. The slowdown in presales from weak demand put financial stress at the project level, which led to a negative spiral of ratings downgrades and a sell-off in bond prices. The property sector faced a classic liquidity crunch.



Akbar Causer
Portfolio Manager
Emerging Markets Team
Eaton Vance
Management



Kyle Lee, CFA
Portfolio Manager
Emerging Markets Team
Eaton Vance
Management

"We strive, as always, to search for mispriced securities in every corner of our investable universe. China property is no exception. We are leveraging our research and network to build a better mosaic as the situation evolves."

According to the most recent data, presales for the top 200 developers were down 40% year-over-year in January. Could this be the bottom? Or will this be the new norm as originally intended by the policymakers?

Policy U-Turn for 2022

In fall 2022, the Communist Party National Congress will elect new leaders for the country, including the president. With President Xi now legally eligible for reelection, there is every incentive to fend off an economic downturn this year.

Since last December, we have seen a coordinated effort by Beijing to reflate the housing sector: The central bank cut the benchmark interest rate for mortgage originations, bank regulators made it easier for developers to obtain loans for M&A, and the housing ministry allowed developers to access presale deposits held in escrow accounts to unleash liquidity. At the municipal level, local governments began supervising project completions and M&A to guarantee final delivery to homebuyers. The macro stars have lined up for the sector to rebound.

Challenges (and Opportunities) Ahead

What seemed like an isolated credit event for Evergrande has now sent shockwaves across the Chinese real estate economy. Within a span of six months, developers, policymakers and homebuyers have pivoted from the best of times to facing the greatest challenge of their lifetimes. International investors should keep a close eye for potential risks of contagion stemming from the Chinese housing sector to global financial markets.

Global investors are still treading carefully, as evinced by the pervasive stress in the credit markets today. A complex web of implicit (and hidden) liabilities onshore make it difficult for offshore investors to estimate a reasonable recovery value for distressed developers. Evergrande's restructuring case has so far confirmed that offshore creditors are indeed structurally subordinated to onshore stakeholders as they await for instructions from the onshore credit committee.

At this stage, it seems to us that there will be a large number of defaults in the sector in addition to the few large developers that have already defaulted. Most of these defaults will likely result in distressed exchange offers, and investors will subsequently have a large universe of exchanged bonds to choose from when deciding where to invest.

Bottom line: We strive, as always, to search for mispriced securities in every corner of our investable universe. China property is no exception. We are leveraging our research and network to build a better mosaic as the situation evolves. As investors with a longer-term investment horizon, we are looking at the directional change for the Chinese property sector, and we are beginning to discover value beyond today's headlines.

The value of investments may increase or decrease in response to economic and financial events (whether real, expected or perceived) in the U.S. and global markets. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical, currency exchange rates or other conditions. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to

decline.



[Accessibility](#) | [Privacy & Security](#) | [Terms & Conditions](#) | [Form CRS](#) | [Contact](#)

To report a website vulnerability, please go to [Responsible Disclosure](#).

Eaton Vance is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley.

For USA PATRIOT Act Disclosure Notice please click [here](#).

The information on this Web site is for U.S. residents only. The information on this Web site does not constitute an offer to sell, or a solicitation of an offer to purchase, securities in any jurisdiction to any person to whom it is not lawful to make such an offer.

There are no guarantees regarding the achievement of investment objectives, target returns, portfolio construction, allocations or measurements such as alpha, tracking error, stock weightings and other information ratios. The views and strategies described may not be suitable for all investors. Not all of Eaton Vance's recommendations have been or will be profitable. Eaton Vance does not provide tax or legal advice. Investing entails risks and there can be no assurance that Eaton Vance (and its brands) will achieve profits or avoid incurring losses. Prospective investors should consult with a tax or legal advisor before making any investment decision.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

© Eaton Vance Management. All rights reserved. Two International Place, Boston, MA 02110