GLOBAL
Insight
WEEKLY

Wealth Management

Perspectives from the Global Portfolio Advisory Committee September 23, 2021

Evergrande(r) debts coming due

Atul Bhatia, CFA – Minneapolis

While the potential default of China's largest property firm shook markets this week, we don't think it's the onset of a systemic event. We separate the real risks from the noise to see the likely impact on global growth and financial markets.

The growing risk of a default by Evergrande, a Chinese conglomerate with a focus on property development, appeared to come to a head this week when the company missed a required loan payment on Monday. Concerns as to the fallout of the potential $305 billion default led the Hang Seng Index to drop three percent and the S&P 500 to decline 1.7 percent on Monday. Markets partially recovered by midweek on news that Evergrande negotiated a deal with bondholders to satisfy an interest payment due this week, although bond market pricing—and credit rating agencies—continues to point toward a high risk of an eventual default.

The size of a potential Evergrande default and its impact on the massive Chinese property development industry may create a longer-term headwind for global growth. But the broader macroeconomic conditions and Chinese policy flexibility mean that concerns over a repeat of the global financial crisis of 2008—or even the Asian financial crisis of the late 1990s—are likely significantly overstated, in our view.

Instead, we see concerns around the policy response and associated risks prompting some near-term profit-taking, which may lead to moderate pullbacks in equity and corporate bond markets. We would highlight, however, that this is not an unexpected or unhealthy outcome at this stage in the recovery, particularly with still strong year-to-date equity market performance.

Low leverage lowers financial contagion risk

Direct contagion from a potential Evergrande default seems unlikely for most developed market securities.

Evergrande's troubles have been well-telegraphed; as a result, few investors are likely to have significant sums borrowed against their holdings of the troubled property developer. We expect this lack of leverage to translate into fewer margin calls as Evergrande's bonds and equity decline, so investors would not be forced to sell other holdings to raise funds.

Nor do we see Evergrande's drop as the initial domino in a broader selloff, much as the Thai baht was at the beginning of the Asian financial crisis. That crisis occurred with significant macroeconomic imbalances, particularly acute among large debtor nations with fixed currencies. Far from being a debtor, China today has one of the largest net creditor positions in the world, which the International Monetary Fund estimates at over $2 trillion; the U.S., by comparison, owes an excess $14 trillion to the world at large. It's true that China's budget has been stretched by the pandemic, but we do not see any shortage of capacity to manage Evergrande and its fallout.

For perspectives on the week from our regional analysts, please see pages 3–4.

Tail risk contained

Without the added complications of debt and leverage, the direct international implications of any Evergrande default on financial markets are potentially limited. But the stakes are higher for the domestic Chinese economy, in our opinion.

Property development is a critical sector, accounting for nearly a quarter of Chinese economic activity. The sector—like real estate everywhere—is also highly levered, with developers completing projects using funds borrowed from banks, bond markets, and individuals.

The combination of leverage and scale amplifies the risks of China's policy response, in our view. Left unchecked, the concern is that Evergrande's problems will set off a negative spiral: forced real estate sales by that company will cause declines in the value of projects of other companies, leading banks and others to cut lending. This lack of liquidity can force more distressed sales, prompting further reductions in lending and a potential disruptive contraction in the sector. Such a chain of events could imperil the banks themselves if land values dropped quickly and deeply enough.

Fortunately, Chinese officials are well aware of the problem, and have already stepped in to provide additional liquidity to the market, adding as much as $14 billion in short-term funds to the financial system on Friday, Sept. 17.

A difficult task ahead

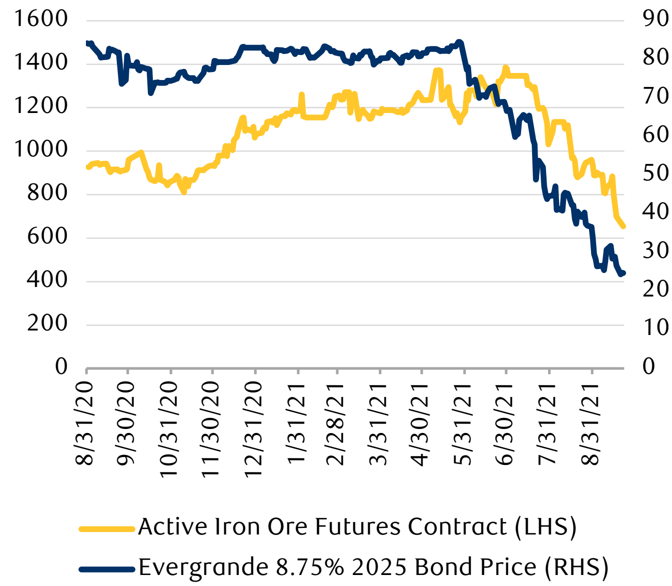
At the same time, Chinese policymakers have been clear that they want to see a gradual deleveraging in the real estate sector and have tightened lending requirements for property developers. This highlights the contradictory requirements for effective policy: it needs to offer sufficient incentives and security to keep lenders providing credit to the sector, while providing enough restrictions to keep credit from growing as fast as or faster than the overall economy.

The result is a very small window for successful policy action, in our view: pressing the brakes too quickly risks a negative cycle that could spiral out of control; applying them too slowly would allow leverage to increase, likely raising the cost of future action.

There are many reasons to believe that China will be able to manage the difficult slowing process. First, it has significant resources. In addition to the huge stock of savings, the country has well-developed capital markets to allocate those savings. China also has experienced policymakers and the benefits of international experience. Finally, even if China's current intention is to force a deleveraging in the property sector, recent global financial history has repeatedly demonstrated that policymakers—when confronted with large market selloffs—tend to prioritize market stability over longer-term policy goals. If China makes the same choice, investors will likely benefit in the short term.

Evergrande woes weigh down iron ore

Potential decline in steel-intense construction activity



Source - RBC Wealth Management, Bloomberg; data through 9/22/21

Even if China avoids a broad market decline, a deleveraging would not be costless. Slowing a sector that accounts for 25 percent of the economy represents a meaningful headwind to domestic growth; China's importance to the world economy means any slowing there would have global implications. We see the potential headwind to global growth as manageable, but we view it as a more substantial long-term concern than the current bout of market volatility.

Policy impacts to be felt globally

Although we see a low chance of a credit markets crisis sparked by any eventual Evergrande default, the task ahead for Chinese policymakers is complex and difficult. We believe that they have the institutional and financial capacity to resolve the issues and that they will avoid sparking a domestic crisis that would morph into an international financial event.

As for equities, pauses or setbacks are a normal occurrence at this mid-cycle stage of the bull market, or once earnings growth has peaked. RBC Capital Markets, LLC's Head of U.S. Equity Strategy Lori Calvasina points out that in the three bull market cycles going back to 1993, the S&P 500 declined by a range of one percent to 7.6 percent in the six months following the peak rate of earnings growth. The effect was temporary, however, and the S&P 500 eventually resumed its upward trajectory. As the situation in China evolves, equity markets could be prone to correction and consolidation, but we would expect a similar constructive pattern to eventually emerge.

UNITED STATES

Alan Robinson – Seattle

- **U.S. stocks started the week on a shaky footing** as the Dow Jones Industrial Average posted its worst one-day loss in four months on Monday, Sept. 20, falling almost 1,000 points before paring its losses by the close. This initial weakness was driven by Chinese corporate debt default concerns (see main article), but stock investors returned to the market later in the week as contagion fears eased.

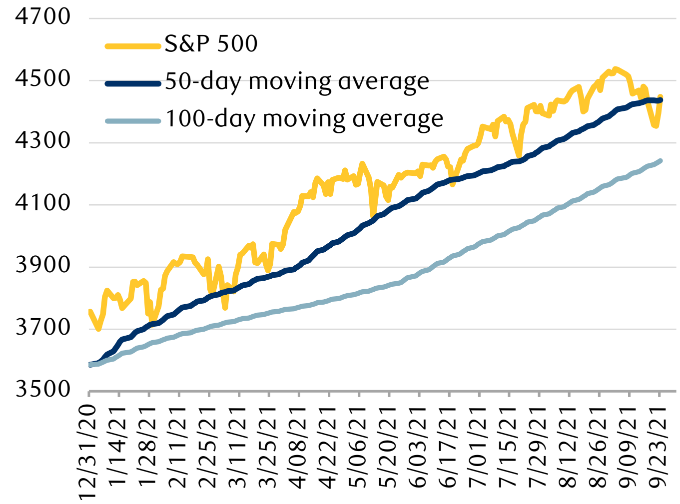
- **However, the rebound still leaves the market a long way from its early-September highs**. Bearish analysts point to the break of the heavily watched 50-day moving average during the week (see chart), while the contrarian bulls say that sentiment is now bearish enough to suggest strength into year-end. RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina noted the recent American Association of Individual Investors survey showed the share of those in the bullish camp fell to 22%, down from 39% the prior week, while bearish investors increased to 39%, up from 27% the prior week. Calvasina ultimately expects a modest pullback in stocks which should be bought, but if corporate earnings growth turns negative, she thinks we could be looking at a deeper selloff.

- **One sign of earnings weakness was provided by logistics bellwether FedEx (FDX)** whose shares fell 9% midweek after reporting an 11% drop in profit due to difficulties in attracting workers. This rekindled wage-related inflation concerns, which were echoed by commentary from the Federal Open Market Committee meeting that concluded during the week.

- **The Fed meeting ended with no big surprises**. Policy remained on hold, but with a hawkish tilt. The Fed signaled that bond purchases should start to be scaled back in November and stop entirely around June 2022. Additionally, nine officials now anticipate an interest rate hike in 2022 compared to seven at the June meeting, while 17 expect hikes in 2023 compared to 13 previously.

U.S. stocks' steady advance hits a speed bump

S&P 500 daily close with 50- and 100-day moving averages



Source - RBC Wealth Management, FactSet; data through 9/23/21

CANADA

Ryan Harder & Luis Castillo – Toronto

- Canadians went to the polls this week for the second federal election in less than two years. With the **Liberal Party being reelected to a minority government**, the vote largely maintained the political status quo in Parliament, and Prime Minister Justin Trudeau will need to continue working with the New Democratic Party or other parties to pass legislation. **For Canadian fixed income markets, the most direct implication is that the path to meaningful fiscal stimulus remains intact**, as the Liberals' election platform included roughly 100 initiatives totaling nearly CA$80 billion in new spending over a five-year period. That figure was not much higher than the Conservative Party's pledge of over CA$50 billion over that same period, but Conservative leader Erin O'Toole did pledge to target a balanced budget in the future whereas Trudeau made no such claim. As a result, the election result does add some incremental expectations to fiscal spending relative to a Conservative victory, which in turn could be supportive of inflation expectations going forward if and when that new spending materializes.

- **Yields in Canada have moved modestly higher across the curve** after touching a recent bottom in early August, **with rising inflation expectations having driven the bulk of the move higher**. The wide gap between U.S. and Canadian 10-year inflation breakevens (which are key measures of market-implied inflation expectations) shrunk modestly, converging by more than 15 basis points (bps) from the mid-August gap of roughly 70 bps. This convergence in inflation expectations between the U.S. and Canada continued in recent weeks, fueled in part by the dual release of Consumer Price Indexes (CPIs) for the month of August that saw the Canadian CPI rising at its fastest pace since 2003, above economists' estimates, while the U.S. CPI came in below estimates. **Despite the recent climb, the market's inflation expectations for Canada remain notably lower than those for the U.S.**

EUROPE

Thomas McGarrity, CFA & Frédérique Carrier – London

- **The STOXX Europe 600 Index recovered from its selloff** on Monday (Sept. 20) amid the broad risk-off move across global markets, to be up over 1% on the week (as of Sept. 23 close).

- **Travel & Leisure was the best performing sub-sector**, up over 4%, as airlines were boosted by the U.S.

government announcing plans to relax travel restrictions in November for fully vaccinated passengers from the EU and UK, while UK-listed sports betting company Entain gained over 15% following an acquisition approach by U.S.-listed DraftKings.

- **Shares of global pharmaceutical group AstraZeneca, the largest weight in the UK's blue chip FTSE 100 Index at almost 7%, gained more than 7%** after announcing positive trial data at the European Society of Medical Oncology conference last weekend. The results of the company's DESTINY-Breast03 trial support the likelihood its Enhertu drug could become the new standard of care for women in the second-line HER2-positive metastatic breast cancer setting, while the efficacy and safety data increase confidence for Enhertu's potential use in earlier-stage settings as well as in other types of cancer.

- **In the euro area, the provisional September services and manufacturing IHS Markit Purchasing Managers' Indexes (PMIs) declined**, reflecting less buoyancy as the economy's initial catch-up phase comes to an end and activity normalizes. The services PMI fell to 56.3 from 59.0, while the manufacturing PMI fell to 58.7 from 61.4, with both figures below consensus expectations. **Supply disruptions not only affected manufacturing but also seeped in to hinder services activity**. Still, despite the deceleration since the peak in activity, the IHS Markit Composite PMI remained well into expansionary territory, at 56.1.

- **In the UK, similar though accentuated trends were observed, with the IHS Markit Composite PMI falling to 54.1**. It is concerning that the rate of growth in new orders slowed to a seven-month low. Looking forward, upcoming withdrawal of fiscal support, tax increases, and a sharp increase in the price of natural gas (on which the country's power system is heavily reliant) may well act to crimp activity further. Gas prices have increased close to 200% since the beginning of the year, due to a confluence of factors including the UK leaving the EU Internal Energy Market.

Natural gas price spike could crimp UK activity

UK natural gas spot price (pence/therm)

Note: A therm is a unit of heat used for measuring gas supply; mid-price on a monthly basis.
Source - RBC Wealth Management, Bloomberg; data through 9/23/21

- **The Bank of England (BoE) stated that it sees CPI inflation in the UK rising to slightly above 4% in Q4 2021 and staying there into Q2 2022**. Consequently, markets have brought forward rate hike expectations, with the market-implied probability of a 15 basis point base rate increase by the BoE in February 2022 rising to over 70% from below 50%. The BoE's February meeting will be telling to the outlook since data on the impact of the UK's furlough scheme ending will be available by then, which is something the BoE wants to see before it starts raising rates.

ASIA PACIFIC

Jasmine Duan – Hong Kong

- **Chinese equities advanced on Sept. 23** amid news that China Evergrande Group (3333 HK) negotiated a plan to repay interest due Thursday on an onshore bond. Evergrande shares surged as much as 32% and closed up 18% compared to the prior close although still down nearly 40% in September. Chinese property, bank, and tech stocks also had decent rebounds for the day, as did Macau gaming companies. In addition, Chinese authorities have begun laying the groundwork for a debt restructuring, which could reduce the risk of contagion to other property developers and the banking sector.

- **Hong Kong property stocks plunged earlier this week** following a Reuters report that said Chinese officials told the city's developers to redirect resources to help solve the housing shortage. However, the Real Estate Developers Association of Hong Kong later said it was unaware of any meetings between developers and Beijing officials. The market expects developers may need to donate some of their farmland to the government for public housing development. Investors are also waiting for more details on housing policy when Chief Executive Carrie Lam delivers her 2021 policy address, scheduled for Oct. 6.

- **China plans to stop building new coal-fired power plants in other nations**, which could sharply limit the worldwide expansion of coal. According to the International Institute of Green Finance, more than 70% of coal plants built today rely on Chinese funding. President Xi Jinping said China will step up support for other developing countries in creating green and low-carbon energy, and will not build new coal-fired power projects abroad. **The move shows China's ambitious carbon zero road map**—its carbon emissions will peak before 2030 and the country will become carbon neutral by 2060.

MARKET
Scorecard

Data as of September 23, 2021

Equities (local currency)	Level	MTD	YTD	1 yr	2 yr
S&P 500	4,448.98	-1.6%	18.4%	37.4%	48.7%
Dow Industrials (DJIA)	34,764.82	-1.7%	13.6%	29.9%	29.0%
Nasdaq	15,052.24	-1.4%	16.8%	41.6%	85.5%
Russell 2000	2,259.04	-0.6%	14.4%	55.6%	45.0%
S&P/TSX Comp	20,461.93	-0.6%	17.4%	29.4%	21.3%
FTSE All-Share	4,081.25	-0.7%	11.1%	24.2%	1.3%
STOXX Europe 600	467.50	-0.7%	17.2%	30.0%	19.9%
EURO STOXX 50	4,194.92	0.0%	18.1%	31.9%	18.6%
Hang Seng	24,510.98	-5.3%	-10.0%	3.2%	-6.5%
Shanghai Comp	3,642.22	2.8%	4.9%	11.1%	22.3%
Nikkei 225	29,639.40	5.5%	8.0%	27.0%	34.2%
India Sensex	59,885.36	4.1%	25.4%	59.0%	53.2%
Singapore Straits Times	3,076.44	0.7%	8.2%	24.0%	-2.1%
Brazil Ibovespa	114,064.40	-4.0%	-4.2%	19.1%	9.0%
Mexican Bolsa IPC	51,464.27	-3.5%	16.8%	43.6%	18.3%
Gov't bonds (bps change)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. 10-Yr Treasury	1.432%	12.3	51.9	75.9	-29.5
Canada 10-Yr	1.343%	12.7	66.6	78.6	-3.4
UK 10-Yr	0.907%	19.3	71.0	68.9	35.5
Germany 10-Yr	-0.258%	12.5	31.1	24.7	32.3
Fixed income (returns)	**Yield**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Aggregate	1.44%	0.3%	-0.4%	0.1%	19.4%
U.S. Investment-Grade Corp	1.98%	0.6%	0.4%	3.0%	27.5%
U.S. High-Yield Corp	3.83%	0.4%	4.9%	11.9%	23.2%
Commodities (USD)	**Price**	**MTD**	**YTD**	**1 yr**	**2 yr**
Gold (spot $/oz)	1,740.56	-4.0%	-8.3%	-6.6%	14.3%
Silver (spot $/oz)	22.52	-5.8%	-14.7%	-1.1%	20.8%
Copper ($/metric ton)	9,301.75	-2.4%	20.0%	40.6%	61.8%
Oil (WTI spot/bbl)	73.45	7.2%	51.4%	84.9%	25.6%
Oil (Brent spot/bbl)	77.23	5.8%	49.1%	84.9%	19.2%
Natural Gas ($/mmBtu)	5.01	14.6%	97.5%	136.0%	98.4%
Currencies	**Rate**	**MTD**	**YTD**	**1 yr**	**2 yr**
U.S. Dollar Index	93.1060	0.5%	3.5%	-1.4%	-5.6%
CAD/USD	0.7898	-0.4%	0.6%	5.7%	4.7%
USD/CAD	1.2661	0.4%	-0.5%	-5.4%	-4.5%
EUR/USD	1.1737	-0.6%	-3.9%	0.7%	6.8%
GBP/USD	1.3719	-0.3%	0.4%	7.8%	10.4%
AUD/USD	0.7295	-0.3%	-5.2%	3.2%	7.7%
USD/JPY	110.3400	0.3%	6.9%	4.7%	2.6%
EUR/JPY	129.5100	-0.3%	2.6%	5.4%	9.5%
EUR/GBP	0.8555	-0.3%	-4.3%	-6.6%	-3.3%
EUR/CHF	1.0859	0.5%	0.4%	0.8%	-0.2%
USD/SGD	1.3491	0.3%	2.0%	-1.7%	-2.1%
USD/CNY	6.4589	0.0%	-1.0%	-7.0%	-9.3%
USD/MXN	20.0436	-0.1%	0.6%	-10.5%	2.9%
USD/BRL	5.3042	2.9%	2.0%	40.4%	27.4%

Equity returns do not include dividends, except for the Brazilian Ibovespa. Bond yields in local currencies. Copper Index data and U.S. fixed income returns as of Wednesday's close. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

Examples of how to interpret currency data: CAD/USD 0.78 means 1 Canadian dollar will buy 0.78 U.S. dollar. CAD/USD 0.6% return means the Canadian dollar rose 0.6% vs. the U.S. dollar year to date. USD/JPY 110.34 means 1 U.S. dollar will buy 110.34 yen. USD/JPY 6.9% return means the U.S. dollar rose 6.9% vs. the yen year to date.

Source - Bloomberg; data as of 4:35 pm ET 9/23/21

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As of June 30, 2021

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Sell [Underperform]	51	3.61	4	7.84

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