

Q&A: WHAT WE'RE WATCHING GIVEN THE CURRENT STATE OF CHINA

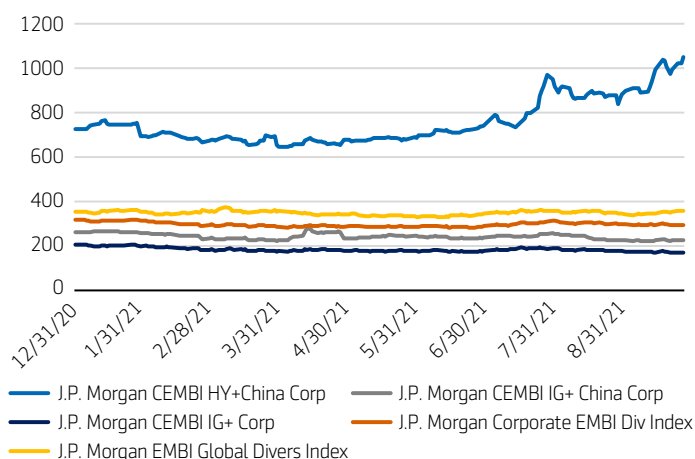
By Phil Torres, Senior Portfolio Manager, Carlos Gomez, Senior Research Analyst & Jeff Grills, Head of Emerging Markets

As the world's largest emerging market, China is always on our radar. However, the recent news of property developer China Evergrande Group has prompted fear in the markets over contagion. Here's what we're saying about the current situation.

Q: Have you seen contagion yet?

EM team: Very limited to date. Evergrande has sold off from 80 cents (c) to 25c while other high yield (HY) property names have moved roughly 80c to 60c, and high quality investment grade Chinese names have fallen roughly 2c. Outside of China signs of contagion have been even more difficult to see. (Exhibit 1).

Exhibit 1: China high yield spreads have widened dramatically, but emerging market debt assets have been minimally impacted.



Source: Bloomberg. As of September 30, 2021.

Q: Evergrande has been likened to China's Lehman moment—some even speculating it is far worse. Do we expect the Evergrande situation to cause broad-based contagion?

EM team: Simply, no. We do not expect any broad exceptional risk events related to Evergrande. We do, however, expect Evergrande to restructure its debts. A recent People's Bank of China (PBOC) stress test examined the impact of property development related loan losses (nonperforming loans (NPL) are up by 15 percentage points) across the entire banking system and found limited systemwide impact (capital adequacy ratio (CAR) moving from 12.3% to 14.4%). We believe the Chinese central government has extensive

resources and desire to ensure the stress to Evergrande and the creditors in its immediate sphere is contained.

Q: Are Evergrande problems symptoms of bigger issues?

EM team: The central government of China is widely reported to have designed this outcome by regulatory action and specifically through the imposition of the "three red lines" to force a deleveraging within the property development sector. We know that real estate, and fixed asset investment in general, became an outsized portion of the Chinese economy and resulted in what is generally considered to be a broad misallocation of capital away from more desirable and productive enterprises. Additionally, several enterprises operating in this sector became highly leveraged. Leaving such fragility in an oversized economic segment was undesirable to economic planners.

We believe the Chinese government seeks financial stability and the regulatory burden that helped cause Evergrande's downfall now was designed to eliminate a true systemic crisis had the size of any future defaults proved larger than the government's resources.

What this likely means is that attempts to reverse GDP growth declines below the annual targeted rate will no longer direct credit toward the real estate sector as a means of fiscal stimulus. We expect China's GDP growth to be modestly more volatile around a lower target rate.

Q: What can you tell us about other companies operating in the same industry as Evergrande? Has your outlook for the industry changed as a result of recent Evergrande developments?

EM team: We believe the property development industry will likely see moderate sales declines and lower profit margins in the near term as the regulatory burden will likely stay unchanged despite Evergrande's debt restructuring. While we will probably see some localized relaxation of mortgage approvals and land auctions, no broad and centralized policy changes are expected given the government's priorities to reduce the high debt levels in the industry. We thus expect

more debt restructurings in the industry as there are still many small and medium-sized developers with what appear to be unsustainable debt levels. We also expect further industry consolidation led by large developers with adequate balance sheets and state-owned enterprises.

It is worth highlighting that the Chinese government is facing a difficult challenge in engineering an orderly deleveraging of the industry. Its policies are likely to have unintended consequences that could cause lasting damage to the real estate industry, particularly in small cities and suburban areas. China's property development industry is largely driven by investment demand, as urbanization trends and population growth have slowed down. In fact, China's home ownership rate is among the highest in the world and it is estimated at over 90% of households, according to Peking University. Any damage to homebuyers' confidence, either through undelivered properties or through sustained home price declines could be difficult to reverse and put the property development industry in a challenging position.

Q: What are you watching to tell if today's Evergrande-specific issues spill-over to broader markets?

EM team: What we view as the three primary signals of contagion and broadening of market stress beyond Evergrande and the Chinese property sector are: 1) excessive deviations in credit spreads on high quality property developers, 2) excessive deviations in credit spreads of large systemic banks, and 3) signs of material currency intervention by the PBOC. To date, we have no noticeable signs of contagion among the prior three metrics we are monitoring.

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Aegon AM US is not currently invested in Evergrande securities.

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