INVESTMENT PERSPECTIVE 3Q 2021

FEELING FOR STONES

New Century Financial Corporation is gone but not forgotten. The 'Official Mortgage Company of NASCAR' from 2006 barely merits a footnote in the annals of the Great Financial Crisis. The headline figures in that saga are Treasury Secretary Paulson, Fed Chair Bernanke and of course Lehman's CEO Dick Fuld. The inauspiciously named mortgage REIT filed for bankruptcy on April 2, 2007. New Century had about a 10% share of the subprime market, second only to HSBC. So, while it was significant, one could have written it off as a rogue bad actor. And it was that, too. At its death, almost half of its prior year's loans had been put back to it for deficiencies. But there was plenty of evidence that this was not an aberration. U.S. home prices had started to decline the prior year. Subprime mortgage delinquencies were already 11% when New Century failed. Even BBB investment grade tranches of residential mortgage-backed securities were already trading at 80% of par. The mosaic coming together was that of a train wreck. Countrywide would implode in a few months. And Bear Stearns' mortgage funds were suspended around the same time. By then the same BBBs were quoted around 50. The point is, there were plenty of moments in 2007 when it was possible to foretell an unwinding.

Enter Evergrande - a troubled Chinese property developer. It has $88 billion of interest-bearing debt outstanding and at least another $200 billion of trade/customer payables. The company has 1.2 million undelivered homes, where purchasers have made a deposit - in many cases for 100% of the sale price. One in four hundred Chinese are actually waiting on an Evergrande home now. If your circle of friends is 100 people, 25% of Chinese actually know one of the aforementioned. Evergrande (unlike New Century, quite appropriately named) is significant.

Taken as a whole, property developers in China have $5 trillion debt outstanding.[1] For context, the balance of all private label mortgage backed securities in the U.S. in 2007 was approximately $2.5 trillion.[2] So Evergrande itself may be manageable. But if its problems are more systematic, then it's going to leave a mark.

The big picture of real estate in China is challenging. Real estate activity contributes roughly 29% to China's GDP.[3] Home prices have risen six-fold in the past two decades. Home prices relative to income in China's Tier-1 cities (Beijing, Shanghai, Shenzhen) are 4x the levels of New York and San Francisco. Real estate loans represent 28% of commercial bank assets. Sales of public land to developers constitute 35% of local government revenues. Housing now represents 78% of household wealth. (vs. 35% in the U.S.). Given a comparable economic output in purchasing power parity adjusted terms to the U.S., the value of real estate in China is twice that of the U.S. ($60 trillion vs. $30 trillion). A measure of unsold inventory to current demand suggests it would take two years at current rates to absorb the supply.

These observations have been true for several years now. The counter argument has always been that rising incomes and demographics would accelerate - allowing China to grow into its valuations. While that might come to pass, there are several hindrances. First, Chinese housing is not under-built. The supply of residential housing space per capita is comparable to Western Europe. For the 276 million urban households home ownership is over 90%. Second, demographics are turning against it as household formations decline. Lastly, leverage ratios have accelerated from 18% to 60% in the past 10 years. So, there's not a lot of unused margin.

Thus far, the bad news. The good news is that the Chinese authorities recognize the bad news. Recall that Ben Bernanke as late as May 2007 was able to say *"We believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."* Rather than waiting for the edifice to collapse, the Chinese are actually conducting a controlled demolition. Can they collapse the overhang while minimizing the spillovers?

The great paradox of Chinese housing is that it's both incredibly expensive and abundant. The solution to the paradox is both (a) the housing is in the wrong place and (b) that many Chinese are sitting on housing as speculative investment. The vacancy rate in China is over 20%. So housing in China is earning a miserable return on investment to society despite spectacular private returns. The Chinese understand this. As early as 2013, during his first year in power, President Xi described the Chinese economy as "unbalanced, uncoordinated and unsustainable." In 2017, Xi announced that "housing is for living in, not speculation."

[1] Wall Street Journal. Oct 10, 2021. Xie, Webb.
[2] Gennaioli, Shleifer. A Crisis of Beliefs. 2018.
[3] Rogoff. NBER. Peak China Housing. 2021.

In this quarter's webcast, we explained the strategic and economic rationale behind Xi's "common prosperity" campaign. Correcting the distortions in housing is a key component. The government will increasingly penalize investment property and subsidize home ownership for the middle class. The long-awaited and just announced property tax is the first step. The transition away from growth at all costs driven by fixed assets to "quality growth" will have severe consequences. As noted above, local government spending, employment and household wealth are woefully dependent on housing. However, the central government controls the banking/credit and tax system. So, they have ample levers to steer the economy and compensate for the damages. They also have deep experience in reform. Deng Xiaopeng described China's development as "crossing the river by feeling for stones." He meant that reforms would be achieved by experimenting, learning and adjusting.

The Chinese are embarking on a giant course correction. It will mean lower returns for businesses geared to the old growth model. But it will also open opportunities for businesses to adapt to the new course. China may present higher risks, but also higher returns. The experience of watching the subprime mortgage rot cascade through our entire financial system until it ground to a halt is seared into the minds of everyone over 35. As a result, we are probably overly sensitized to the tail risks of dislocation. The comforting fact is that the people who definitely have not forgotten New Century Financial are the Chinese economic leadership.

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