MPL WEALTH MANAGEMENT

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The Ides of……..September

It was an interesting third quarter for the global economy. In July concerns regarding the financial position of China Evergrande, the world's most indebted property developer with liabilities/debts in excess of US$300 billion (including US$20bn in outstanding Dollar Bond debt) gained traction, and were seen as threatening to other Chinese property developers and to investor sentiment toward the country as a whole.

In short, back in August last year the Chinese regulator sat down with 12 "pilot" property developers including China Evergrande to introduce a new policy capping three debt ratios known as the "Three Red Lines"; putting it simply, this forced financial deleveraging on the developers so to improve the overall financial health of the Chinese real estate sector. This in effect weakened China Evergrande's access to funding and in tandem its ability to service its huge debt mountain, rendering a default on interest payments on the company's debt pile more likely. After being initially ignored by financial markets, the growing threat of an Evergrande debt default began to affect investor sentiment across the globe during the third quarter and contributed to the increased market volatility we saw during this June-August period, and then into September which is itself traditionally a tricky month for investment markets.

Real estate is a very important component of the Chinese economy and a major contributor towards its GDP growth, and is fundamental to the financial wellbeing of so many Chinese families, given that homeownership rates in the country run to over 90%. The concern was that because the Chinese economy is now so large and so integrated into the global economy, this issue could affect the rest of the world's markets – in short, the Chinese economy would suffer as a result of any major Evergrande debt default, which would then cause the global economy to suffer contagion from it.

As the consumer is also a large factor in the Chinese economy and again an important contributor to GDP growth, any major factor adversely affecting its housing market and its perceived negative force on the so-called 'Wealth-Effect' of owning an appreciating housing asset, could easily have negative knock-on effects on Chinese domestic consumption. That could then bleed into other regional and global markets through a weakening in the Chinese import markets, as well as a slowing in demand for all sorts of raw materials upon which Chinese economic growth depends.

Whilst Evergrande's collapse would be the biggest test China's financial system has faced in years, market participants however correctly believe that the Chinese authorities (who have a high level of control over and involvement in China's real estate industry) will act quickly to contain the situation, and they have past experience of doing just that.

In 2018, the private insurance group Anbang was brought under state control and restructured after its collapse with more than $320bn in liabilities. The regional lending bank Baoshang was

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allowed to go bankrupt in 2020 after racking up $32bn in debts - $26bn in public funds were used to help rescue creditors at an average repayment rate of under 60 per cent. Billionaire Wang Jianlin (touted as China's wealthiest individual as recently as 2015), meanwhile was forced earlier this year to downsize his property and entertainment conglomerate Dalian Wanda, and rein in its $75 billion debt pile as Beijing clamped down on firms borrowing heavily to finance a push for growth overseas, thus limiting access to capital.

Earlier this year, HNA — one of China's largest global asset buyers with $77bn in debts — was taken over by state bankruptcy regulators and split into four separate entities. And most recently, Huarong, a state-owned asset manager with $15.9bn in losses, was partially bailed out by state-owned investor groups after its chair, Lai Xiaomin, was executed for corruption in January.

When it comes to estimating the scale of any potential impact on international financial markets however, these events are not on a par with the 2008 Lehman Brothers collapse, and in some senses the hype surrounding them has been overdone in the short term. China Evergrande for instance principally holds property assets, while Lehman held financial assets - the latter leading to serious questions over the financial stability of many major banks within the global financial system, which also held similar assets – this in turn led to the Great Financial Crisis of 2007-9.

Evergrande still has options to sell off parts of its land bank and complete development projects, thereafter selling them to start paying down debt. In addition, the levels of government control mentioned earlier are a result of many Chinese banks and other financial / manufacturing entities being government arms. Non-state owned financial entities can also be controlled to an extent not seen outside China, hence commercial bankruptcy there is not so much determined by market forces, as by the State.

In the background to the Chinese property market problems meanwhile the widely-mentioned issue of more persistent inflation continues to bother financial markets; the jury is still out as to whether current levels of inflation caused by issues ranging from supply bottlenecks, tight labour markets, and other factors arising from the global pandemic are temporary, but time will tell over the next six to eight months as consumer items used within the annual inflation basket calculation are changed.

The chart below highlights the impact of these various issues upon the assets held within MPL client portfolios since 30th June 2021. Unsurprisingly, equity assets within both developed South-East Asian markets and those within Emerging Markets generally, have been most impacted by concerns about inflation and interest rates, as well as the regional impact of the Evergrande debt saga.

Interest rate-sensitive assets such as corporate bonds, property, and infrastructure, also tracked back in the quarter as investors mulled the prospect of potential interest rate increases here in the U.K.

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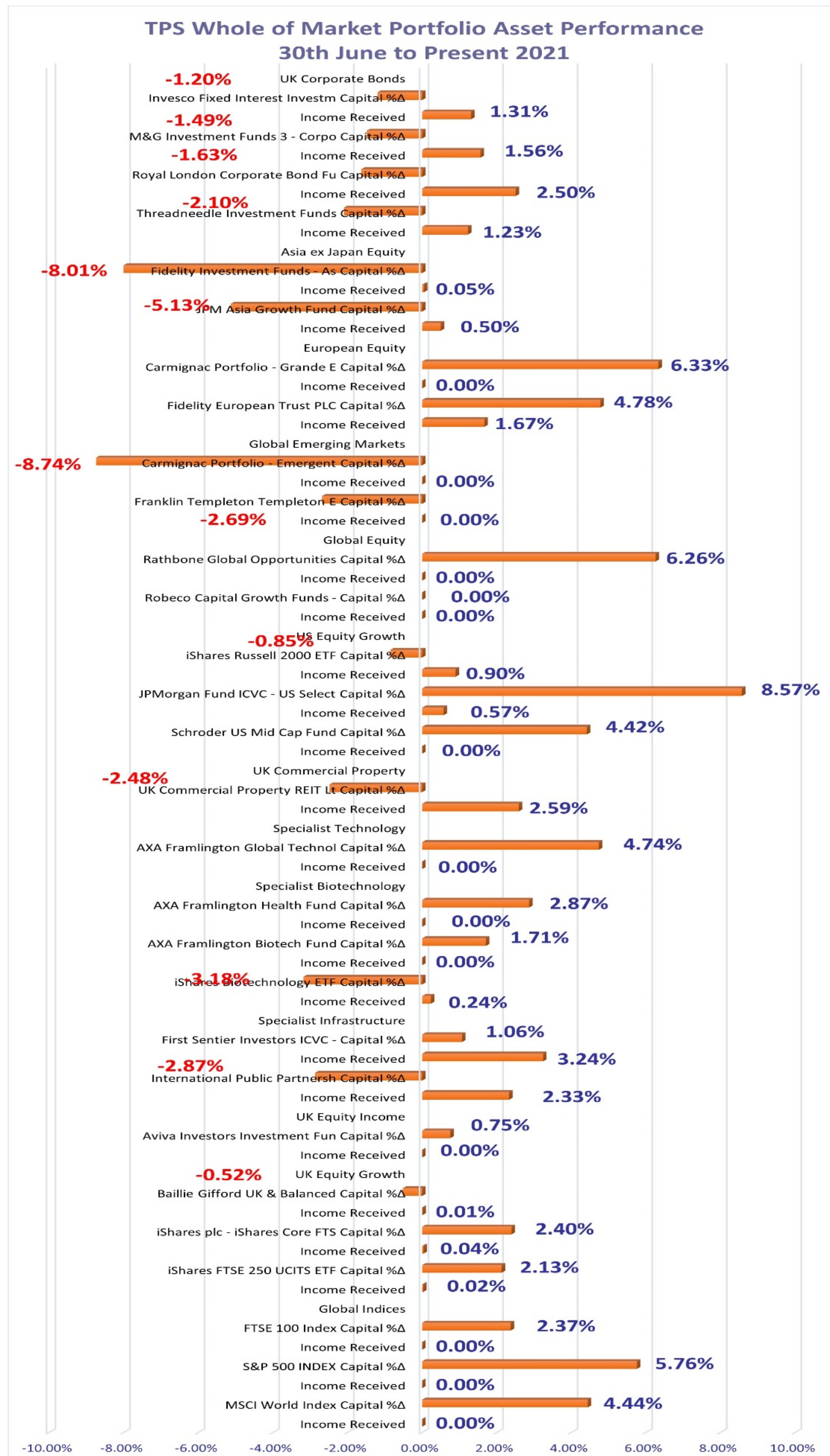

Source: MPL Wealth Management

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Portfolio Changes

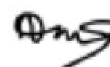
With client portfolios performing well in the period from May through to early September, the MPL Investment team took some profits across the equity and commercial property holdings of the portfolios. Then during the recent market weakness, some of the proceeds from these sales were reinvested into global funds focused upon sectors the MPL team feel will perform well in future, driven by and in line with gradual monetary policy changes that we expect to come from global central banks.

We continue to expect that the Global Consumer Discretionary Sector will outperform the expectations for earnings growth of most if not all other market sectors, and will do so within the next couple of years as the global economy regains its footing post the pandemic. Companies within the Healthcare, Information Technology, Communications Services, Industrial, and Financial sectors are also expected to perform quite well, with financial markets rewarding this anticipated earnings growth via share price appreciation.

Within the UK, we have reduced our exposure to the broad UK FTSE-100 and -250 Indices, with more focused exposure to companies within the aforementioned sector groups via the Baillie Gifford UK Alpha Fund, and an increased weighting in the Aviva UK Equity Income Fund.

Following this theme, we will also shortly be initiating a new weighting into the Robeco Global Consumer Trends Fund. In the US equity area, we have switched holdings from the JP Morgan US Equity Income Fund into the JP Morgan US Select Fund. In Asia, the Scottish Oriental Investment Trust has been sold in favour of the JPM Asia Fund, together with an increased weighting within the Fidelity Asia Fund. These moves are aimed at giving the portfolios greater exposure within these regions to our more closely targeted investment themes.

With Kind Regards



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