

Why We Follow Market Signals, Not Narratives

The Evergrande saga has been dubbed by some in the financial media as “China’s Lehman moment”. This description sounds like journalistic short-hand ie: big crisis in a large systemically important institution must equal China’s Lehman moment. The comparisons don’t stack up however and if Evergrande really is the next Lehman, we need to watch out below, as the S&P 500 fell 37% in 44 trading sessions after the Lehman fiasco 13 years ago. But how do we know? How can we tell whose story is right and whose prediction to trust? The answer for me on this question is very straightforward: we look at the market signals and ignore all the narratives.

To start with let’s just briefly reprise some of the details of the Evergrande scandal. Evergrande is the second biggest real estate developer in China. It has over 800 projects in 200 cities but has overstretched itself and is currently \$330bn in debt and cannot meet its interest payments. It has been under scrutiny by the Chinese government, which does not like seeing individuals becoming billionaire property developers. It follows on from the broader crackdown that the Chinese have brought to bear on the Education, Gaming and Technology sectors.

Evergrande Share Price over 1 Year



The first thing to note, shown by the chart above, is that this is not a new phenomenon. Although most of the coverage has only recently come to light, this has been a problem for Evergrande’s share price for a year now. This is a big problem for the Chinese as their Communist ideals clash with Capitalist realities. But the key question is, will there be contagion? Is this an event that will truly unsettle investors on a global scale?

For the answer to this, we look to the credit markets. Global contagion would be expressed quickly and definitively in the credit markets if there were a systemic problem. So, what happened on Monday in the credit markets was critical to understanding how the market

viewed this so-called contagion. We look at the spread between 3m bills vs the overnight rate in the major markets. The TED Spread, which is 3m Treasury Bills over the US interbank rate, widened by 1 basis point. The Euribor-OIS spread, the European version, was flat and remains negative. The CDOR OIS spread, the Canadian version, moved by just 1 basis point. The Chinese Interbank rate tightened 11bps day over day, all of which sent the clear message that there was no fear of contagion in the credit markets. Calm also prevailed in the bond markets, with yields rising, reflecting a risk on attitude.

The S&P 500, however, was weak on Monday, falling a quick 2.87% to an intraday low, as the “news” on Evergrande hit the mainstream media outlets and the front pages of newspapers. But a quick look at credit markets told us that there was no contagion risk and that any dips in the equity markets should be bought. Indeed, the S&P 500 has rallied 3.32% since that low to the close on Thursday.

Whilst the Evergrande situation is a serious one for its shareholders, bondholders and the Chinese government, it is not for shareholders in US companies. Despite all the scare stories, that probably generated plenty of clicks and attracted a lot of eyeballs, this was all just another noisy story. But this was only knowable by looking to the market for its message rather than relying on the ‘China experts’ wheeled out for yet another opinion.

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Data source: Hedgeye Risk Management; Bloomberg

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