Gold and a Chinese Credit Event

Mining Sector Insight

By Paul Mylchreest

Gold and a Chinese Credit Event

A Western phenomenon?

Gold holders of the world unite

If you own, or are considering owning, gold or gold equities, it's likely that you're concerned about protecting your wealth, or the performance of your fund, in the expectation of some kind of financial instability. Maybe your confidence in policymakers is ebbing, or you've researched debt bubbles in history and concluded that physical gold and silver have been the safest places to be invested when they unwind. Maybe, you can't put your finger on it. You don't know where it might come from, but something doesn't feel right.

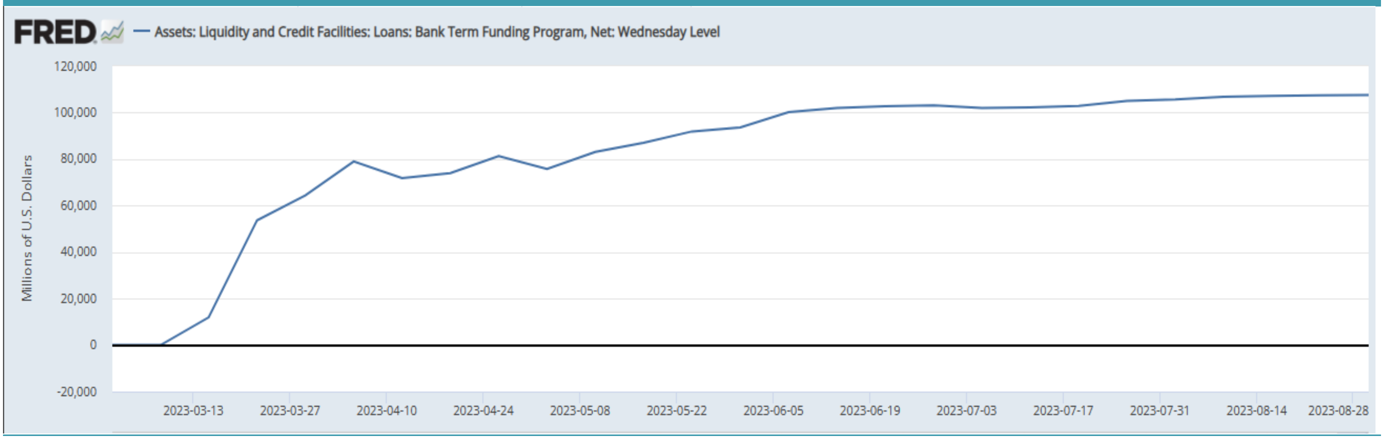
Have we been conditioned regarding financial instability?

It's debatable whether we've been conditioned as investors to assume that financial instability is a Western phenomenon. The bursting of the tech bubble and Lehman's failure have conditioned us to focus on Western financial systems for sources of financial turbulence. The failure of Silicon Valley Bank (SVB) on 9 March 2023, followed shortly after by Signature Bank and First Republic, focused attention on the US as a source of systemic risk once again.

It almost happened again in US regional banks this year

The Fed's rapid increases in interest rates led to huge unrealised losses on bond portfolios held on the asset side of regional bank balance sheets. This led to a credit event in the form of old-fashioned bank runs with customers pulling deposits, a source of funding on the liability side. Forced to sell bonds, banks crystallised losses, rapidly turning some of them insolvent. A $400bn infusion of life support from the FHLBs (Federal Home Loan Banks) and the Fed's Bank Term Funding Program (BTFP) pulled us back from the brink. While investors' attention has shifted, the support remains in place and the BTFP recently posted a record $107bn high.

Federal Reserve Bank Term Funding Program (BTFP, $tr)



Source: FRED

Gold price performance amid the regional banks' crisis

The gold price put in an interim low of $1,813/oz on 8 March 2023, the day before the crisis emerged. The following day, SVB's share price plummeted 60% after it announced a $1.8bn loss on the sale of $21.0bn of securities and $2.25bn of capital raisings. First Republic Bank collapsed on 1 May 2023 and was taken over by JPMorgan Chase. Gold performed strongly during the crisis, reaching a price of more than $2,050/oz on 4 May 2023.

The next crisis is always different to the previous one

There's no rule stipulating that the next phase of financial turbulence has to begin in the US, or any Western nation. Regulators and politicians are not famed for their crystal balls and usually act after-the-fact to ensure no repeat of the latest crisis.

China enters the crosshairs

China's economy barely broke its stride following the 2008 crisis…

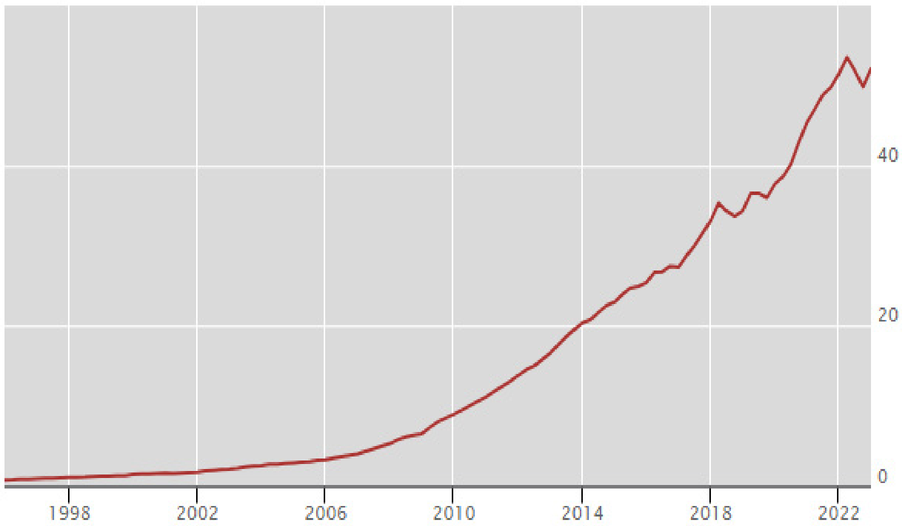
Strong GDP growth and buoyant asset prices, fuelled by abundant credit expansion, can mask many structural problems, blindsiding regulators. It happens time and time again. The economic landscape is always changing and one economy's relentless expansion has dwarfed all others in the past two decades. Remember China's resilience after the 2008 Great Financial Crisis? China's GDP growth in 2007 was 14.2% (OECD 2.7%), dropping to 9.7% in 2008 (OECD 0.4%) and 9.4% in 2009 (OECD -3,4%), before recovering to 10.6% in 2010 (OECD 3.1%).

Where did that resilience come from? It wasn't exports.

…because debt exploded

It was an unprecedented expansion in debt by central/local government and commercial banks, coupled with an explosion of leverage in China's nascent shadow banking sector. This shifted the driving force of growth from exports to domestic investment. The Chinese government's post-Lehman stimulus package was $588bn, about 13% of GDP at the time. However, driven by government directives and growth targets, the economic stimulus provided by debt has been magnitudes larger. Since 2008, total debt to the non-financial sector, as defined by the Bank for International Settlement, has risen from about $5tr to more than $50tr.

China total debt to non-financial sector in US dollars ($tr)



Source: BIS (Bank for International Settlements)

China's debt/GDP is about 300%…

China's national debt/GDP ratio (including central and local government debt) was 76% at the end of 2022, up from 27% in 2008. JPMorgan Chase has estimated China's total debt (government, households and companies) at 282%, but this might be on the low side. Overall debt to GDP, taking into account other lending – including leverage in the shadow banking sector and off-the-books lending – is likely to be around 300%.

…and the economy is going in the wrong direction

A number of China's headline economic indicators are trending in the wrong direction:

- QoQ GDP growth for 2Q'23 missed expectations, slowing to 0.8%, from 2.2% in 1Q'23;

- the economy is teetering either side of deflation – having slipped into deflation with the July 2023 CPI falling 0.3% compared with a year ago, August 2023 posted +0.1% (PPI -0.3%);
- exports fell 14.5% and imports fell 12.4% compared with a year earlier in July 2023;
- youth unemployment (age 16-24 years) climbed to a record 21.3% in June 2023, prompting officials to stop reporting it; and
- investment in real estate for January-July 2023 fell 8.5% – residential housing, about three quarters of the total, fell 7.6%, and has been deteriorating.

Drilling down into China's financial system, two interconnected sectors – real estate and shadow banking – are in turmoil.

Real estate crisis

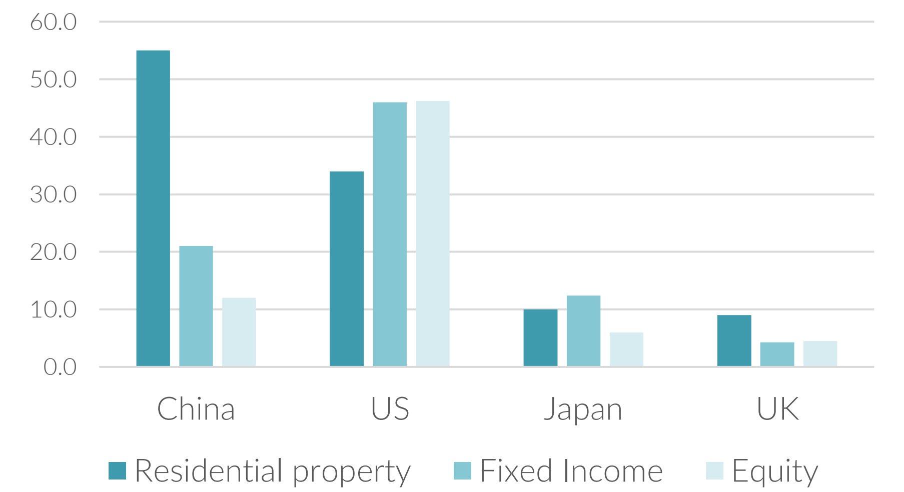
Real estate probably accounts for 25%-30% of China's GDP

We need to shed light on the Chinese real estate sector due to its sheer size and its ties to the broader financial system, including shadow banking. Taking into account the entire supply chain, several commentators, including CaixaBank, have estimated that real estate accounts for 25%-30% of Chinese GDP.

Chinese real estate is potentially the world's largest asset class

It's not widely appreciated by Western commentators that the Chinese real estate market is potentially the largest single asset class globally.

Chinese real estate – value vs. other major global asset classes ($tr)



Source: Hardman & Co. estimates

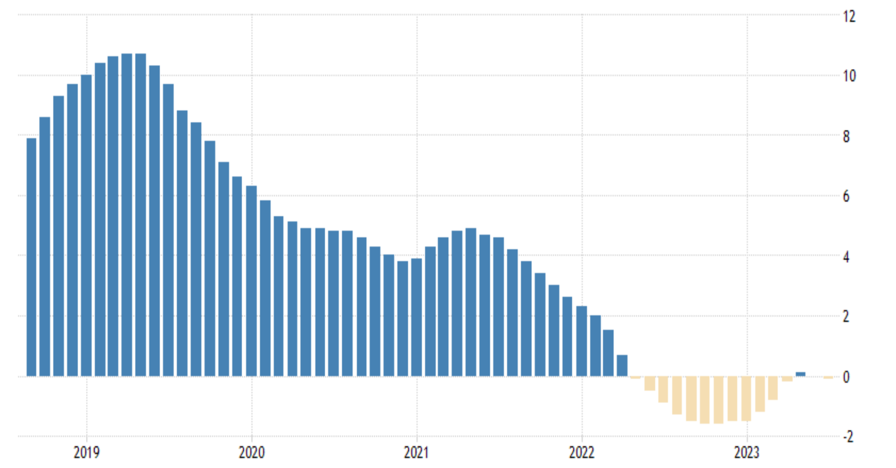
It's not easy to work out how much trouble the real estate market is in

In early-August, Fu Linghui, a spokesperson for the Chinese statistics bureau noted that "The overall real estate market lately is in an adjustment phase, where certain developers are encountering certain difficulties." The question is to what degree Fu is a master of the understatement? And working that out isn't exactly straightforward.

Official data says Chinese house prices are down slightly…

The official data from the National Bureau of Statistics shows that house prices have come under modest pressure since 2Q'23.

China house prices: YoY change in 70 major cities (%)



Source: Trading Economics (www.tradingeconomics.com)

...but, in reality, prices are probably down more than 15%

Based on these figures, house prices for the 70 major cities are about 6% off their peak. However, some commentators are beginning to doubt the data. The methodology is based on selective sampling from surveys, not actual transaction data, and the true situation may not be palatable for communication by officials. A recent Bloomberg report noted that existing home prices have fallen by more than 15% in several major metropolitan areas and in more than half of the nation's tier-2 and tier-3 cities. A July 2023 report from Leyoujia, a property research institute, estimated that prices have fallen 15% in districts of Shanghai and Shenzhen.

Pre-selling homes creates a Ponzi-element to the market

The impact is already being felt by numerous property developers, including some of the largest, and having a knock-on effect on China's financial system as a whole. On 19 August 2023, Market Watch reported that companies accounting for 40% of Chinese home sales have defaulted on debt payments since 2021. Many property developers pre-sell homes, providing finance to fund their operations; the downside of this being the introduction of a Ponzi-style element to the industry. However, buyers are unlikely to continue paying for properties from companies that may not be able to finish building them.

Evergrande still on the brink of bankruptcy...

Until recently, the poster child for China's real estate woes was property giant Evergrande Group. It has been teetering on the brink of bankruptcy since defaulting on its debts in 2021 and has notched up reported losses of $81bn during the past two years. With an estimated $328bn in liabilities, as of June 2023, Evergrande is believed to be the world's most indebted property developer. It's also one of the largest – its website stating that it has 1,300 real estate projects in 280 Chinese cities.

...its share price has collapsed as the restructuring continues

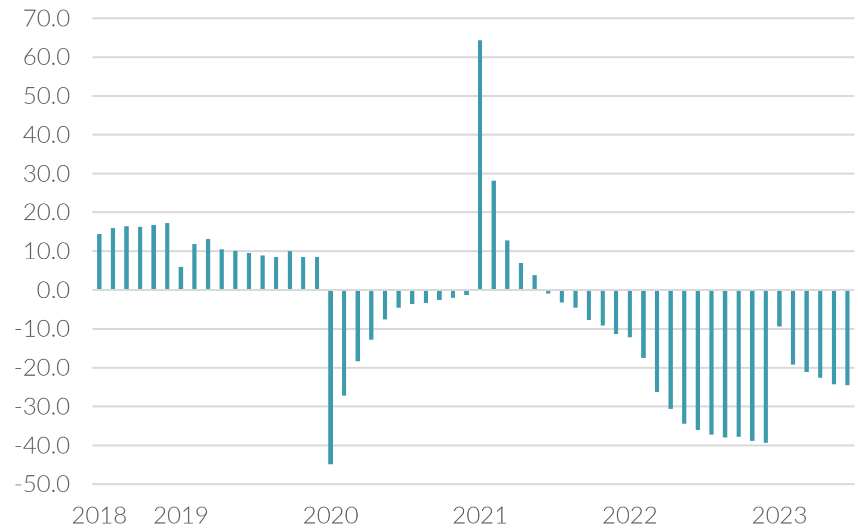
Evergrande is desperately trying to restructure its debts. It filed for bankruptcy protection in the US on 17 August 2023 in a bid to protect its US assets while it re-negotiates with creditors. Following a 17-month halt, the shares resumed trading on 28 August 2023 and promptly fell 80% on the day (taking the market cap to about $600m versus a peak of $50bn). Voting on its offshore debt restructuring plan has been delayed until late September.

Another of China's mega property developers, Country Garden, is also in trouble.

Country Garden is days away from default

Country Garden's share price collapsed to a recent low of HKD0.70, down 74% since the beginning of 2023, and 94% in the past five years. At the end of 2022, liabilities totalled $199bn. Its portfolio includes more than 3,000 housing projects, around 60% of which are in China's smaller cities. In mid-August, the group missed a series of bond coupon payments, totalling about $22.5m, and suspended trading of 11 onshore bonds. It is now part way through a 30-day grace period before formal default. On a brighter note, having been due to make a RMB3.9bn ($540m) payment on an onshore private bond on 2 September 2023, the creditors are allowing the group to make the payments in instalments over three years.

Chinese housing starts floorspace YoY (%)



Source: China National Bureau of Statistics

Chinese property developers could owe as much as $390bn

Gavekal Research has estimated that unpaid bills from private Chinese developers amount to approximately $390bn.

The problems have spread to the state sector

However, the problems are not confined to the private sector. State-owned Sino-Ocean Group Holding, a Hong Kong-listed medium-sized developer, defaulted on a $20.9m interest payment on $700m notes, trading of which has been suspended. This followed the default on a $275m five-year bond on 2 August 2023. The company is working on a debt restructuring plan. Reports suggest it has halved the price of apartments in Fuzhou in a move to raise cash.

There's another piece to this jigsaw.

Real estate meets shadow banking

China's shadow banking sector is estimated at $7.3tr

How big is shadow banking in China? A Bloomberg report from 30 March 2023 noted that Moody's Investors Service estimated that lending by Chinese companies not possessing a banking licence is $7.3tr, or about 40% of GDP. Growth in shadow banking credit creation exploded after China sought to accelerate growth following 2008's GFC.

The biggest subsector is trusts

The most common form of shadow banking funds accessed from the public are trusts (maybe as much as $4.5tr), Wealth Management Products (WMPs) and private equity. The attraction to the public has been higher rates of interest than traditional bank deposits and the impression of safety, since many have been sold by large banks. Funds are pooled by shadow banking entities in the form of loans to local government financing vehicles (LGFVs), real estate developers and other corporate entities.

Shadow banking caricature

Source: Mises Institute

Chinese authorities became concerned in 2016, but this had an adverse effect

Realising they had lost control, Chinese authorities attempted to rein in the growth in shadow banking after 2016. While this brought down the rate of credit creation in shadow banking, it prompted some real estate developers to access funding by pre-construction sales, as noted above.

Zhongrong Trust is in trouble

Zhongzhi is one of China's largest shadow banking operators with interests in WMPs, trust companies and private equity. It manages around $140bn in assets and has a 33% stake in Zhongrong Trust, which has missed about $20m of interest payments on dozens of products in recent weeks. The Washington Post reported that Zhongrong has $86bn of trust assets under management, making it the ninth biggest trust in China. Use Trust estimates the average yield on these products is 6.88% versus the benchmark 1.5% rate on one-year deposits paid by banks. Reports in the Chinese media suggest that Zhongrong has no immediate plans to cover the missed payments. The company has hired KPMG to audit its balance sheet.

The authorities have stepped in

More importantly, the financial regulator, the National Financial Regulatory Agency, has stepped in and two large state-owned financial firms, Citic Group and China Construction Bank, have been brought in to examine Zhongrong's books. This signals the level of concern on the part of the Chinese government. If trusts default and home buyers start refusing to buy properties before they are constructed, access to funding for China's real estate sector could be significantly curtailed.

Big picture impact

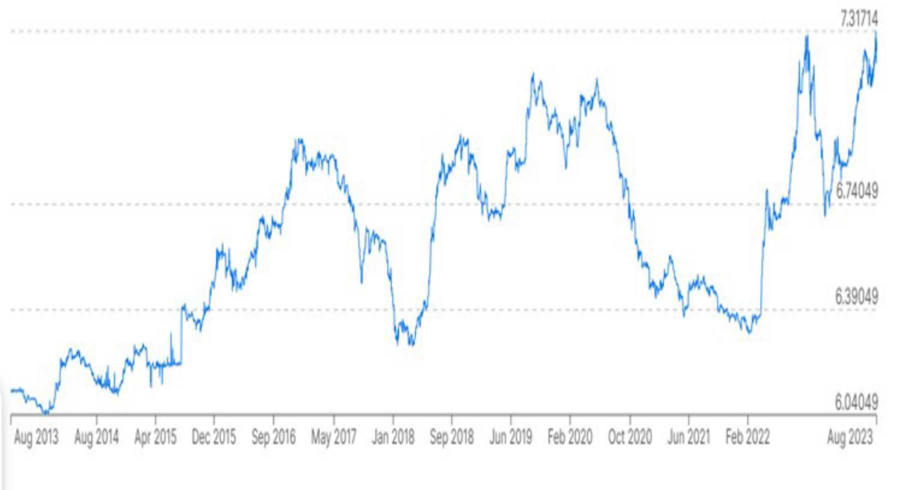
The word "contagion" is starting to be used

With major real estate and shadow banking companies in trouble, the dreaded word "contagion" is starting to be used in relation to China's vital real estate sector and, potentially, further afield.

RMB has come under severe pressure

Global markets have reacted to the turmoil in China's financial system and heightened credit risk by pushing the RMB to its lowest level in more than a decade. After touching 7.35 against the dollar, the PBOC (People's Bank of China, the central bank) instructed state-owned banks to intervene and stated that it will "resolutely prevent over-adjustment in renminbi".

USD to RMB, 10-year historical performance



Source: Yahoo Finance

Authorities have begun to take countermeasures…

The authorities are beginning to acknowledge the scale of the problem and are taking action. Initial measures included:

- reducing the rate floor on mortgages for new homes in over 100 cities; and
- the PBOC cutting the medium-term lending facility (MLF) rate twice, most recently from 2.65% to 2.50%, to stimulate more bank lending.

…most recently, to prop up China's stock market

In late-August, further measures were forthcoming. However, it was noticeable how these were aimed at providing short-term support for China's stock market:

- stamp duty on stock trades was reduced by half by China's Finance Minister;
- the Securities regulator announced that it will slow the pace of IPOs and lower margin requirements; and
- to avoid one-sided equity market conditions, some quantitative T+0 trading algorithms were suspended.

Shanghai Composite has shown surprising resilience in contrast with Hang Seng

Indeed, we had been surprised by the resilience of the Shanghai Composite Index. From its interim peak in early August, the index had declined by a modest 7% before these measures were announced. When markets opened up on the Monday morning (28 August 2023), the 5.5% rebound had faded to little more than a 1% rise by the close. In contrast, Hong Kong's Hang Seng Index fell 12% intra-month and 22% from its 2023 high before the recent recovery.

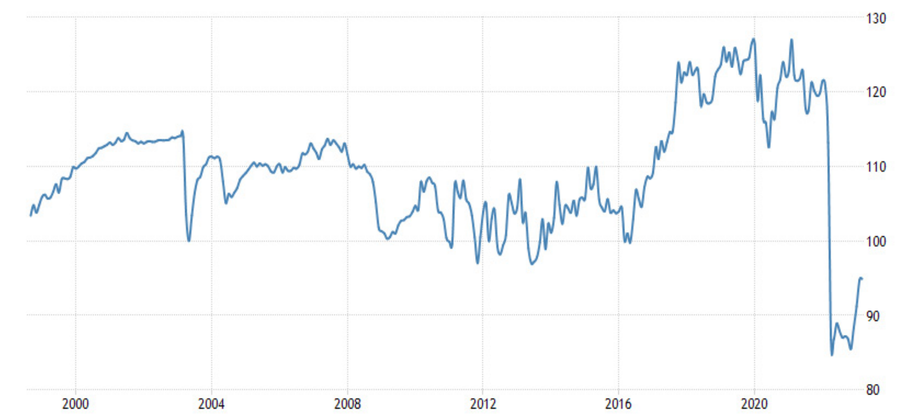
Hang Seng Index since October 2022

Source: Trading Economics (www.tradingeconomics.com)

A big sell-off in equities might be devastating

Chinese policymakers' focus on avoiding a sizeable correction in stocks while it struggles to resolve the real estate and shadow banking turmoil is understandable. A big sell-off would be highly damaging to confidence in crisis-hit real estate and would be rapidly transmitted to the Chinese financial system as a whole. Consumer confidence has already cratered.

China Consumer Confidence (25 years)



Source: Trading Economics (www.tradingeconomics.com)

In our view, policymakers are behind the curve…

From our perspective, the authorities are currently behind the curve in dealing with the threats to China's financial system. More action is required, and sooner rather than later. Key questions are:

- can they get ahead of the curve and avoid a credit event; and
- if so, what is the scale of measures required, likely many hundreds of billions of dollars or more.

…and have not responded in their customary fashion

For the time being, most commentators are attaching a relatively low probability to a financial crisis in China. So far, however, the authorities have not responded with their typical *modus operandi* when faced with a risk of this nature; i.e., heavy-handed monetary stimulus in a variety of forms.

Potentially looking at a credit event

If they don't get to grips with the problem, we are potentially looking at a Chinese credit event, which would have ramifications across global asset markets. It would likely reverse the "higher for longer" narrative of central banks across the world, bringing on a prolonged period of coordinated easing. We saw what happened to gold in the aftermath of the SVB failure earlier this year and it would be reasonable to expect a strong rebound in the gold price as investors flock to safe havens like gold and perceived safe havens like US Treasuries.

Gold price in RMB close to all-time high

If the Chinese authorities get ahead of the curve and provide bailouts and stimulus on a large scale to manage the crisis, they may save the economy, but the RMB is likely to take the brunt of the adjustment with FX outflows accelerating. China (individuals and the central bank), along with India, are the world's largest buyers of gold. The next chart shows the gold price from the standpoint of a Chinese investor. In RMB terms, the chart looks bullish with the price close to its all-time high.

Gold price in RMB/oz since 2006

Source: Refinitiv

"Too big to save"?

While we were preparing this report, we saw an estimate that the cost of bailing out the real estate sector to the Chinese government would amount to about $1tr. In recent weeks, Bloomberg Economics has estimated that property developers face an RMB18.9tr liquidity shortfall ($2.6tr) – equivalent to about 15% of GDP – that could become a solvency crunch by the end of 2023. It described the property sector as "Too big to save".

Spot price premium in Shanghai

Returning to gold, there have been times in recent weeks when the Shanghai spot price has traded more than $40/oz higher than London spot gold – the biggest premium in over five months. It reflects tighter supply in China as the authorities have taken action to reduce gold import quotas to some banks. No explanation has been given, but it may be one in an array of measures to support the RMB at this time.

Investors unexcited by gold miners' prospects

From the perspective of Western investors, they are less focused on investing in physical gold and tend to buy both physical gold and gold mining shares. The GDX Gold Miners ETF includes most of the major global gold mining and streaming companies, including Newmont, Barrick Gold, Franco-Nevada, Agnico Eagle, Wheaton Precious Metals, Newcrest Mining and Gold Fields. It shows how there is surprisingly little investor excitement regarding the prospects for gold miners.

GDX Gold Miners ETF since 2007

Source: Trading View

There is less interest in junior gold mining stocks, as shown by the GDXJ Junior Gold Miners ETF. These stocks are, typically, more highly geared to a rising gold price and are waiting for the catalyst of renewed strength in gold.

GDXJ Junior Gold Miners ETF since 2010

Source: Trading View

About the author

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Paul Mylchreest is an equity analyst covering the Mining sector at Hardman & Co.

Paul has 30 years' analytical experience, having started his career in the Chemicals sector. He was an Extel-rated analyst at S.G. Warburg, Schroders and Citibank. As well as a brief foray into Oil & Gas, he worked for several years as a Global Macro & Cross Asset strategist, firstly setting up on his own, and later working at US commodity trader, Archer Daniels Midland (ADM Inc.). He began his mining coverage at Crédit Agricole Chevreux in 2005.

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