August 2022 High Yield Market Insights

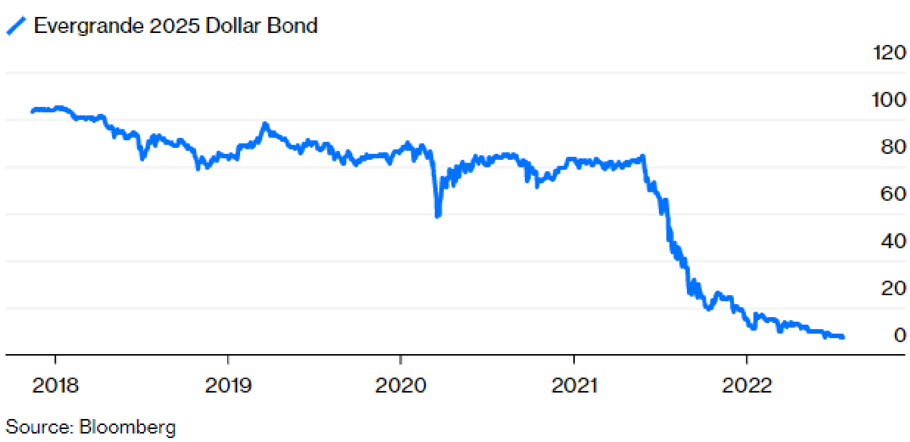
- Chinese high yield bonds trading for pennies on the dollar might seem like opportunities for outsize profits, but investors must understand the surrounding circumstances
- High yield bonds issued offshore alongside domestic debt with collateral that cannot be seized are probably not the best investments no matter how cheap they appear
- Debt governed by US law with accessible collateral is preferable for this kind of investment

Any tenured high yield investment manager should have experience with restructurings or default scenarios. Concise Capital invests only in developed markets like the US, Canada and Western Europe. We do not invest in Chinese debt, or the debt of any other emerging markets issuers. This insights piece aims to illustrate why.

Chinese developers issued over $100 billion in offshore debt to help fund building projects. These bonds are trading at cents on the dollar. If these were US issues, their prices might indicate an opportunity to buy the bonds, restructure the companies and turn a profit.

Below is a USD bond from Evergrande, a large Chinese developer with an estimated $300 billion in debt, most of it onshore in renminbi. $20 billion of its debt is offshore in USD. Evergrande defaulted at the end of 2021. It has not produced a restructuring plan but has sold or exchanged some of its offshore assets out from under offshore bond holders. Other developers such as Shimao, Kaisa and Yuzhou have since defaulted on their offshore debt as well. Their bonds are also trading at very low prices.

Figure 1: Evergrande dollar bond



No doubt some brave souls are buying this debt, thinking they will be able to force outcomes similar to what would occur in the US, or other countries with established bankruptcy laws. Those outcomes typically involve erasing the equity holders and taking control of the company or seizing properties. This is wishful thinking in China. Foreign investors will be at the end of the queue for any recovery.

The US and Chinese financial systems are vastly different, making the outcomes we expect from distress vastly different too. Buying high yield debt in emerging markets, where the rule of law is tenuous, foreigners have little recourse and the authorities will put their constituents first, is a risky investment strategy.

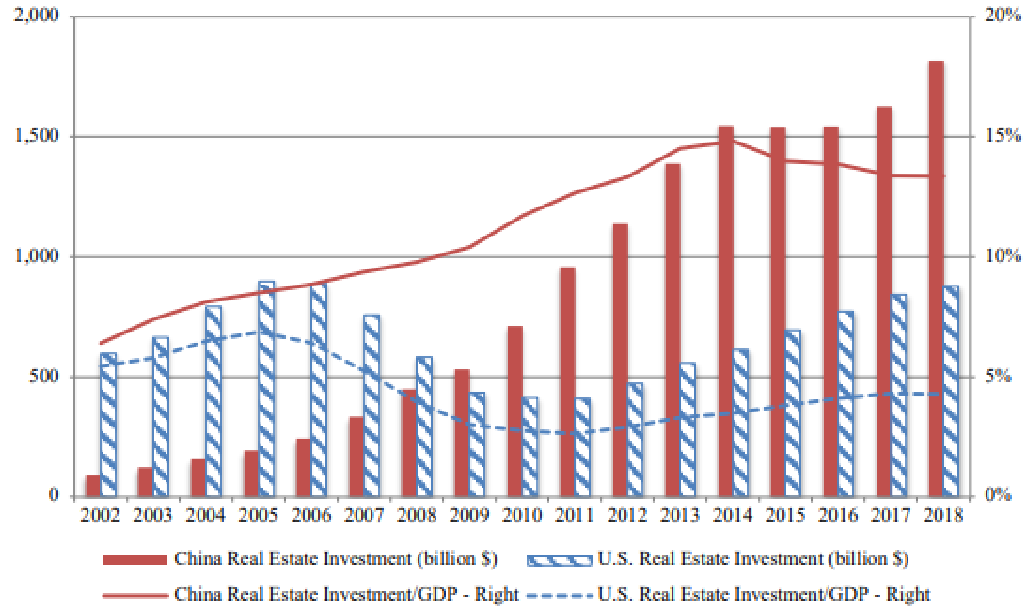
Less than fifteen years ago, the US went through a housing crisis that led to extraordinary price declines across homes, stocks, investment grade bonds and high yield bonds. It was a systemic event that left many unemployed and devastated the savings of others. The US banking system came close to failing, forcing the government to step in and bail it out.

This all happened as the share of housing investment in US GDP touched 6.7%. That doesn't seem very high, but the borrowing to support it, combined with thinly capitalized banks and hedge funds, made it enough to take the financial system to the brink of failure.

China is now going through its own housing crisis. Private individuals are not making mortgage payments on undelivered properties. Housing investment is far more important to Chinese GDP than it ever was in the US, it reached 13% in 2018.

Figure 2: Housing investment in US and Chinese GDP

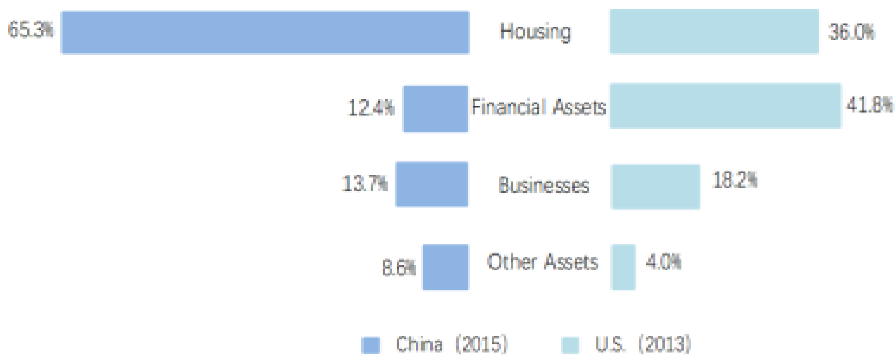
This figure shows annual real estate investment in China and the United States from 2002 to 2018. Real estate investment is placed on the left axis, and the ratio of real estate investment to GDP is placed on the right axis.



Source: U.S. Department of Commerce Bureau of Economic Analysis

Housing also makes up a higher proportion of personal assets in China than it does in the US. It comprised 65% of household wealth in China in 2015. In contrast, US individuals hold significant amounts of financial assets and businesses in addition to homes.

Figure 3: Composition of households' assets, China v US



Source: IMF

And now we come to the kicker, the way Chinese residential property is financed. If you are from the US and are buying a newly built home, you put down a deposit and wait for your house or condo to be built. No one will give you a mortgage until the home is delivered. A mortgage is secured by collateral. No home, no collateral.

In China, this is upside down. You can mortgage an unbuilt home. Chinese developers finance a material portion of their building via individuals' deposits. Those deposits are financed by mortgages. This is what the mortgage strikes are about. People are paying for homes that are unfinished and likely never to be finished because the developers have run out of funds.

The state is stepping in. Local governments are taking over and completing housing developments. Even in an authoritarian country, you need to appear legitimate to your populace. Individuals have become senior creditors, arguably the most senior creditors. All local creditors, individuals, banks or local governments will get paid before foreigners, whether in cash or via delivery of their prepaid apartments. This is known as structural subordination and should have been seen as a possible outcome by any offshore investor. As the saying goes, (foreign) "devil take the hindmost."

Figure 4: Chinese developers' sources of funds