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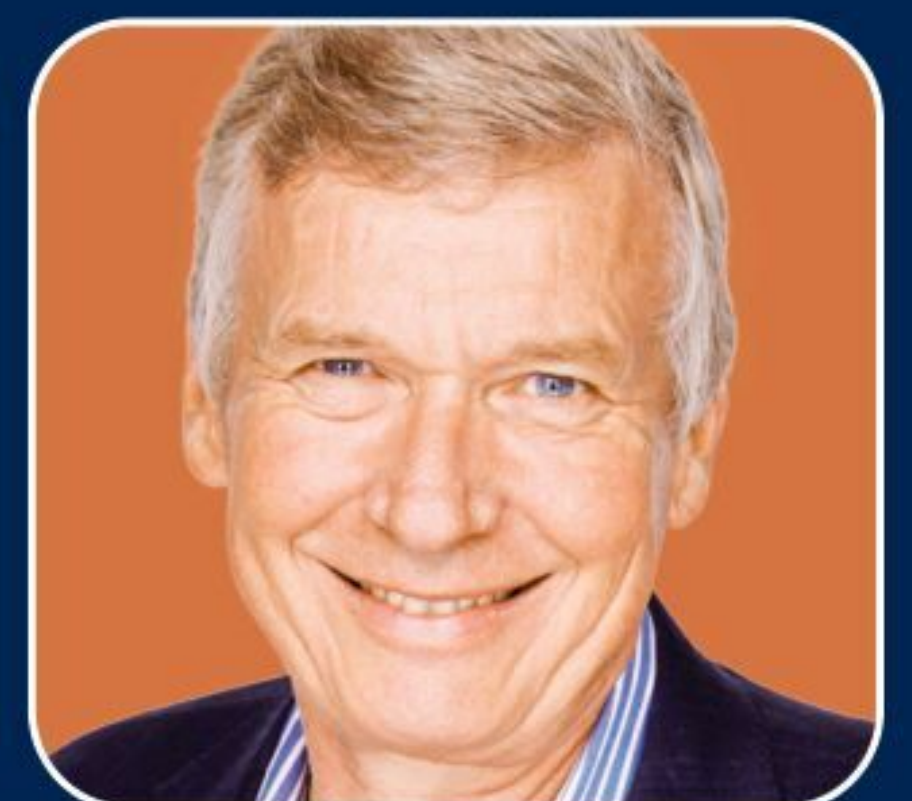
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What the Evergrande crisis means

As the dust settles, investors should watch for opportunities in high-yield Asian debt

The news of China's largest property developer failing to meet its obligations to its creditors has sent shockwaves through the Asian fixed-interest markets. So exactly what risks and opportunities does this shock bring for investors in Asian high-yield debt?

To understand Evergrande's fallout, one must understand the backstory to China's property market. Chinese property developers have enjoyed an exponential rise in their revenues over the past decade from 4.4 trillion yuan (almost \$1 trillion) in 2009 to over 16 trillion yuan in 2020. The activity in the main has been focused on developing residential, rather than commercial, real estate.

Property prices as recently as 2019 were growing as much as 10% a year, but slowed to mid-single-digit growth over 2020-2021. House prices have more than doubled since 2015, which is not too dissimilar to the residential increases in developed nations (including Australia) over the same time period.

Many investors observe China's property market with much scepticism, as though it survives on unchecked economics. There are often other headlines mentioning roughly a quarter of investment properties in urban China sitting vacant, with overall rental yields under 2%. But if you look through the fear-inciting headlines, there are other facts that offset the concerns.

First, China's urbanisation trend has

continued since the 1960s and now sits at 60%. This trend should continue for another 15 years to reach an 80% urbanisation rate, which is roughly where the US is today. Chinese government policy encourages urbanisation, as it is obviously much more cost-effective to service a densely packed population with infrastructure, utilities and civic services. Furthermore, China is a planned economy, so the government tends to plan and layout infrastructure and encourages property investment ahead of the migration trend to newly built cities.



There have been many places that have been reported as ghost cities in the past that have gone on to become bustling metropolises, such as Pudong in Shanghai.

Now, back to Evergrande, which is the largest property developer in China, with liabilities totalling about \$420 billion. It has more than 1300 property projects on its books across 280 cities as well as other businesses such as food manufacturing and wealth management. The wheels started to come off for Evergrande recently when the Chinese government effectively told the banks to cap lending to dampen house price growth. This meant that buyers found it difficult to get loans and settle on properties, causing Evergrande to suffer a fall in sales activity; cash inflows were insufficient to cover the costs, wages and debt servicing.

This sent a wave of fear among investors holding high-yield dollar-denominated

3 FUNDS TO WATCH

1 VanEck Emerging Income Opportunities Active ETF

Holds a globally diversified portfolio of bonds and currencies in emerging markets. It aims to provide total investment returns, measured over the medium to long term, in excess of the benchmark.

2 Bentham High Yield Fund

Aims to provide investors with a diversified exposure to the US high-yield securities market with active allocation among individual securities and industries.

3 iShares Global High Yield Bonds ETF

Aims to provide investors with the performance of an index before fees and expenses that is designed to measure the \$A hedged performance of fixed-rate, high-yield corporate bonds across global developed markets.

debt in Asia, which traded down well below par value on the assumption of imminent defaults and insolvencies across the property sector in China. The current sell-off in Asian dollar-denominated high-yield debt is the most significant since the previous sell-off in March 2020, which was followed by a massive rally back to normalised levels.

At the time of writing, the interest payments missed by Evergrande have entered a 30-day grace period and if they remain unmet, formal default is a certainty followed by debt restructuring. Given the size of the company and the domino effect it would have on the cost of capital across the property market in China, we see the probability of a contagion as low with the more likely scenario being a debt restructure facilitated by the Chinese government and pain being mostly limited to Evergrande's bond holders and other creditors.

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