Evergrande: What to Do as the Body Floats Down the River

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"If you wait by the river long enough," said the ancient Chinese scholar Sun Tzu, "the bodies of your enemies will float by."

Sun Tzu's quip came to mind this week as a drama unfolded in China with Evergrande. The firm has massive debt – well over $300 billion – and minimal money to pay interest, let alone repay principal.

Indeed, as the week progressed, Evergrande offered excuses and a mere few, token payouts. These included offers of title to real estate in lieu of cash. While many Evergrande employees learned that they are not going to be paid. Definite cash flow problems on display here, right?

It's more than that though. Evergrande highlights how we're deep into a global liquidity crisis, coming at the end of a ridiculously expansive period of worldwide money creation. Yet despite all the currency issued by central banks across, many big players are broke, if not insolvent.

Media are filled with forecasts of how an Evergrande crash will lead to a major global meltdown, the "next Lehman Brothers" as many have phrased it. Evergrande will smack the global economy like a big asteroid.

Well, there's no extinction-level event just yet. Everything is playing out day by day, and as the matter comes into better focus it's evident that the whole affair is not unexpected.

Evergrande has long been known for its growth-by-debt approach to business. It overpaid for land, labor and materials. It overbuilt hundreds of major projects across China, many becoming those infamous empty, “see through” cities out of some science fiction movie.

Many wondered how this could go on, because it didn’t make sense. And guess what… it was pretty much a fake form of business and development.

Ponzi-like (or to use a more recent analogy, Madoff-like), Evergrande remained afloat for as long as the company could raise cash from sales, from deposits for new projects and a revenue stream of new, gullible investors.

But there’s no stopping the clock. At some point, and certainly, as the business climate played out after 18 months of Covid, there would come a day when the scam ran its course. Hence my thoughts about Sun Tzu, an allegory supporting the virtue of patience. Give things enough time and eventually, the bodies float by.

What does it mean to you? At this stage, whatever happens with Evergrande will happen. It’s not that the firm is “too big to fail” in China. In fact, I suspect that Chinese leaders would be happy to see a bigshot, go-go business cut down to size, and arrogant managers publicly humiliated, if not standing in a court dock charged with economic crimes against the state.

At the same time, Evergrande has hundreds of thousands of employees and millions of indirect hires based on its development work. China’s leaders cannot afford to let things get too far out of hand, leading to large-scale job losses and social unrest.

Expect some form of government-backed restructuring of

Evergrande, with limited payouts to the small but numerous stakeholders, and other cash to domestic suppliers. Also expect to see China stiff many foreign creditors, such as hedge funds and banks who bought into the Evergrande promise. Many write-downs lay ahead for those foreign devils.

Meanwhile, something even more important is afoot. Evergrande's collapse is a clear sign that many other overextended plays across the world are about to hit their own brick walls. They may be smaller than Evergrande, but cumulatively they add up to more asteroids raining down on the global economy, one after another.

In other words, investors large and small are about to rediscover the meaning of investment risk as a decade of up-up-up markets confront the realities of too much debt and not enough cash flow.

Frame it as many discrete, sector bubbles about to deflate in a disorderly way. And please don't think that you can outplay an avalanche.

Safe havens include cash, of course. Precious metals too, although when markets sell down abruptly even gold and silver take big hits, but only because they're liquid. People sell what they must to raise cash, not what they might like to sell, especially when markets go no-bid for shares of crummy companies.

This mess is not over, It won't be over any time soon. Step aside if you can. And whatever you do, don't become one of those bodies in the river.