Evergrande is part of a deliberate move by China: Devina Mehra of First Global

"The Chinese government wants to let a few businesses fail to rein in a bigger problem ... The situation is similar to a controlled detonation. For all practical purposes, a default of Evergrande has already been priced in," says the Founder of the brokerage.

N MAHALAKSHMI | SEPTEMBER 21, 2021 / 09:50 PM IST

Devina Mehra is one of the sharpest minds in the Indian stock markets. An IIM-A gold medallist and Founder of institutional broking firm First Global, Mehra had led research at the broking firm. Her more recent accomplishment is to have built the machine-plus-human approach to investing. First Global is one of the first Indian brokerages to start tracking US stocks way back in 2001, and Mehra has a keen understanding of global markets, and, yes, when it comes to market predictions, she has several firsts to her credit.

In an exclusive interview with Moneycontrol, Mehra talks about the default of Chinese property developer Evergrande, its impact on the Indian market, First Global's top stock and sectoral picks and more.

Edited excerpts:

Q: How big an issue is Evergrande?

A: In our view, the issue is part of a deliberate move by the Chinese government to let a few businesses fail, to rein in a bigger problem. So, they will not let it go out of hand. The situation is similar to a "controlled detonation". In a relatively controlled-economy like China, this is entirely possible. This is in contrast to several somewhat sensational reports and videos floating around.

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And for all practical purposes, a default of Evergrande has already been priced in and not just its own bonds - even overall high-yield bonds in China/ Asia have already reacted. So, there's not much further downside there.

Apart from real estate, tech and consumer discretionary, which have also been areas of government crackdown, other parts of the Chinese economy continue to be robust. That is where we are placing our faith.

The primary casualty of the contagion, if any, will be the banking sector. That is a sector we are anyway underweight on.

Q: How much China allocation do you have in your global portfolio?

A: Overall, our exposure to China is just 2.3 percent, well below its representation in the benchmark indices, where the weightage is close to 4 percent. We are in sectors that are more robust -- like clean energy, semiconductors, footwear and chemicals.

We have not taken any direct exposure to the finance and property sectors in China. We also cut out the consumer internet/ tech stocks. A few months ago the government pressure increased in various ways on companies like Alibaba, Tencent, etc.

We will be watching the developments very closely, but one way or the other, it is not going to affect our global fund/ portfolio, materially.

Q: You clearly do not think the Chinese real estate crisis is comparable to the US financial crisis … Like you mentioned, there are some voices comparing it to the Lehman crisis.

A: We don’t think anyone realistically sees Evergrande as a Lehman, but we’ve also seen these periods of China deleveraging weakness before and they aren’t fun. We don’t need the 0.01 percent tail event to be concerned.

However, given the amount of publicity it has already received, property developers and financiers who have already seen credit spreads widen - people are struggling to find even a single bank to sell them a CDS on Evergrande. Effectively, a default risk is already built in, with its bonds trading at 20-30 cents on the dollar.

Q: How do you see this news playing out in the near term? It seems to be impacting sentiment, at least for now…

A: Beijing's focus is on reining in the property sector, which has been highly levered for some time now. But Beijing does not want consumers to suffer. So, the only solution is restructuring and a slow burn in the property sector.

As of June, Evergrande's inventory (consisting of largely unfinished projects) accounted for about 60 percent of its total assets. Properties under development, in particular, ballooned to 1.3 trillion yuan ($202 billion) -- a 54 percent jump from three years ago.

If only Evergrande could offload some of these projects to, say, a cash-rich state-owned enterprise, its immediate liquidity crunch would be resolved. Beijing would then have some breathing room to gradually scale down this beast.

Meanwhile, this would, by extension, impact the construction space and industrial commodities in China. Steel and iron ore are already under pressure due to Beijing's "Blue Skies" mission for winter Olympics. In order to reduce emissions, they're restricting steel production. Iron ore is anyway trading below $100 now. Australian miners can take a big hit and they already are.

Q: What kind of trades are you recommending to investors with a global risk appetite?

A: Our basic stand is always to err on the side of caution and risk-control.

Since we run long-only strategies, even stocks or areas we do not like, we just steer clear of them rather than shorting them.

With that caveat, our view is that if you were to go with the proposition that Chinese banks can blow out in a tail-risk scenario, you're better off betting against Chinese banks/NBFCs with a high exposure to property-related sectors and the least support from the People’s Bank of China (PBOC), i.e., private banks.

We don't think the PBOC will let big banks collapse, considering each of the Big Four banks remain wholly or predominantly state-owned and headquartered in Beijing.

Another possible pessimistic trade is to bet against investment grade names in the real-estate space. The Bloomberg China HY USD index is 66 per cent-real estate. Hence, when you look at the aggregate index, it is mostly a real-estate picture you get.

If you dig into the other parts of the index, the message is quite different, at least for now. It is hard to find big companies outside real estate that have seen significant spread-widening. So far, we think this a China real estate- specific problem. This is not to say that 'everything is fine'. It is just to be precise about what type of contagion we are observing.

Q: What do you think will be the impact of the Chinese government efforts to rein in Chinese real estate on global commodity demand, supply and prices? Do you think Indian metal stocks, like Tata Steel, have over-run their course?

A: Metals, including steel, had been big winners in our India portfolio from the third quarter of 2020 but we had started trimming these a few months ago.

One reason is that we estimated that the US would try to curb commodity inflation by strengthening the dollar, which actually happened. China has been curbing its own steel consumption for environmental and other reasons.

However, I think the primary impact of this has been and will continue to be on iron ore prices and stocks - especially, Australian miners. Indian steel stocks, while no longer the best bets in the market, don't appear particularly bad either.

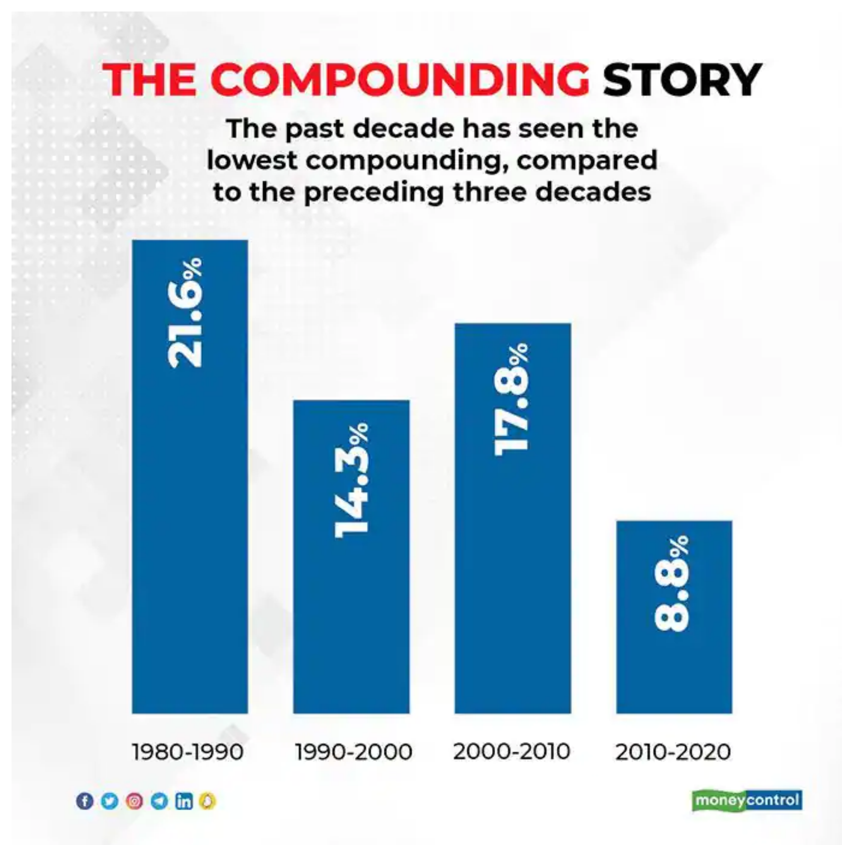
Q: What are the key variables you will be watching over the next few days and weeks to see if things may get out of hand?

A: Our systems continue to monitor all macro and market variables for all major economies as well as industry-level data. Like a hare, we remain alert, scanning the environment and ready to change direction if the situation so warrants.

As of now, we are not worried about a contagion from this particular event, but we continue to monitor potential risks.

Q: From an Indian market perspective, how do you think the risk-reward is poised for overall markets?

A: Someone recently shared the BSE SENSEX historical data with me, which shows that in the past decade, we have seen the lowest compounding (See chart).



Inherent in these numbers is the risk-reward in the market. Prior to this run, the whole decade gave very sub-normal returns.

As per our Lake of Returns Theory (LORT), returns crash and a bear market comes when the returns have been substantially above trend for a reasonably long time.

As this table shows, we have not had a sustained bull market. Hence, the risk of a sustained bear market is also lower. We have not even come to normal trend returns.

Hence, while corrections can be expected, our systems do not indicate risks of a significant bear market.

Q: Do you think the risk to Indian markets hereon is more local or global? Could you elaborate with data points?

A: We don't think we are through with the pain points in the domestic economy, with recovery still some way away when you benchmark with pre- COVID levels. Consumer distress also remains. To that extent, we are still lagging many other countries.

Globally, for now, COVID-related news remains a risk area. Inflation is not out of hand, at least in the developed world. Hence, the tightening cycle there remains some way away.Some of the emerging market players, however, have already been tightening. If India does not follow suit -- my bet is that it will not -- currency could be a risk area.

Q: What are your top stock and sectoral picks right now?

A: We have a very diversified basket, with no outsized bets on any single sector. Currently, our relatively higher weights in the India portfolio will be IT, chemicals, cement, and, more recently, telecom.

We continue to be underweight on financials as we think the risks there remain relatively high with considerable pain in the economy.

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