



A Financial Crisis Is Brewing in China. Will It Spread?

Evergrande, a Chinese company with over \$300 billion in debt, is failing. Will it get bailed out, and if so how? While investors focus on the nuts and bolts of Evergrande, we sense a financial crisis of sorts is brewing in China. Given China is the world's second-largest economy and driver of global growth, our focus turns to the possibility their financial crisis spreads beyond the Great Wall.

Trading might be volatile today due to quadruple witching in the options and futures markets. That said equities, bonds, and the U.S. dollar are trading relatively flat in pre-market trading this morning. The primary focus today and early next week will be on the Fed's FOMC policy meeting on Tuesday and Wednesday. It is widely expected they will announce a taper timeline starting at the early November FOMC meeting. Investors will take their cue from the pace of QE as well as any stipulations that might derail, slow, or speed up the process.

[dmc]

What To Watch Today

Economy

- 10:00 a.m. ET: **University of Michigan Sentiment**, September preliminary (72.0 expected, 70.3 in August)

Earnings

- *No notable reports scheduled for release*

Market Update

While investors did show up to BTDFD yesterday, the "buying" was less than impressive. In recent months, when the market has touched the 50-dma, there were impressive rallies that pushed the markets back to all-time highs over the next couple of days. That aggressive buying has not been evident as of yet. With options expiration completing today, maybe we will see some buying again later this afternoon.

However, at the open this morning we are not seeing any follow-through as of yet with futures pointing lower.

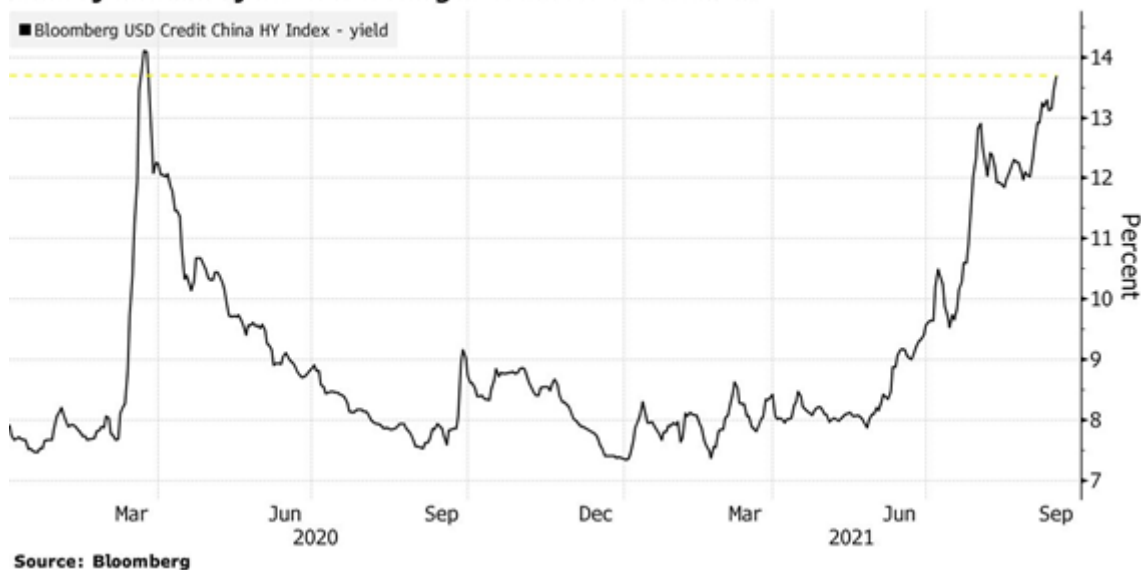


Junk Bonds in China

The graph below continues our discussion of Evergrande. Yields in China's junk bond market have doubled since late May. The problems facing its property markets and economy, in general, are widespread. China's junk bond yields are back to levels when COVID first roiled markets. As a comparison, BofA's B-rated U.S. junk index is 4.41%, well below 12.50% from March 2020.

Evergrande Spillover

China junk bond yields are at highest since March 2020



Retail Sales on Fire (Sort Of)

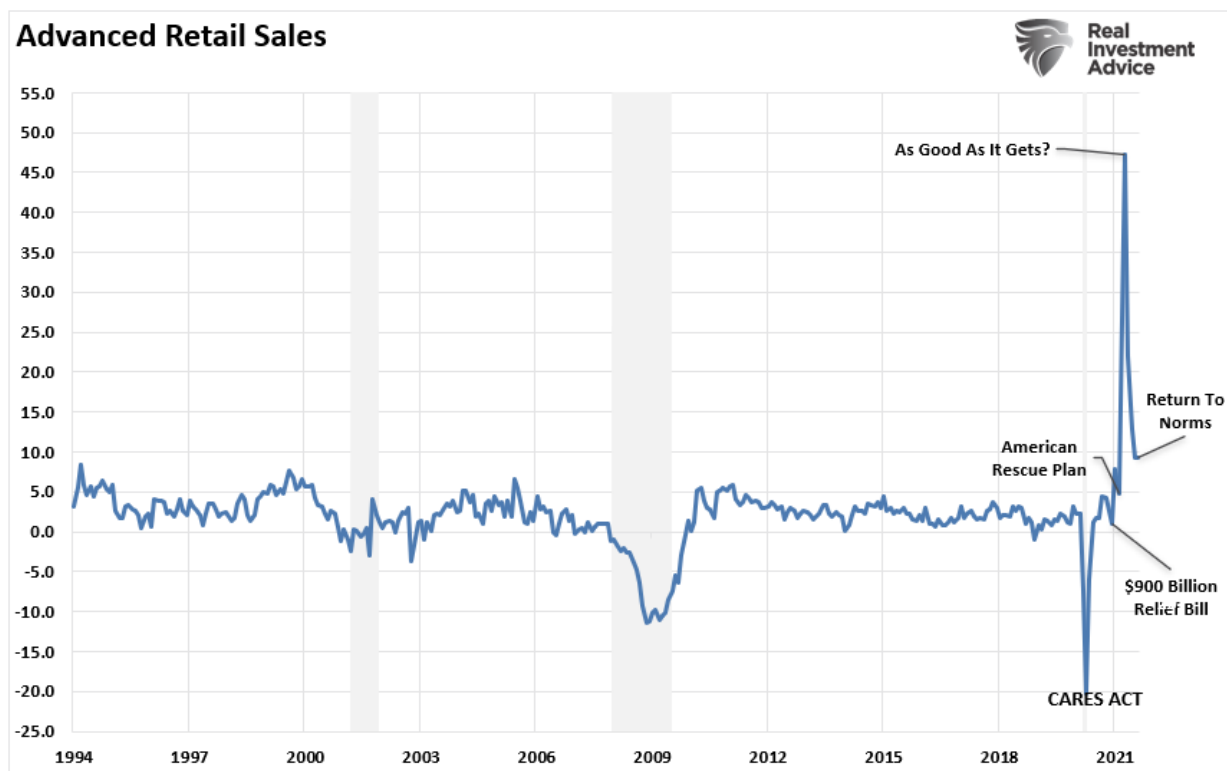
[U.S. Retail Sales](#) unexpectedly rose 0.7% in August versus an expected .8% decline. However, last month's data was revised from -1.1% to -1.8%.� Excluding gas and autos, sales rose 2.0%. While the data is economically positive, the markets may not like it as it bolsters the rationale for tapering.

The media exuberance was on bull parade yesterday as noted by Yahoo:

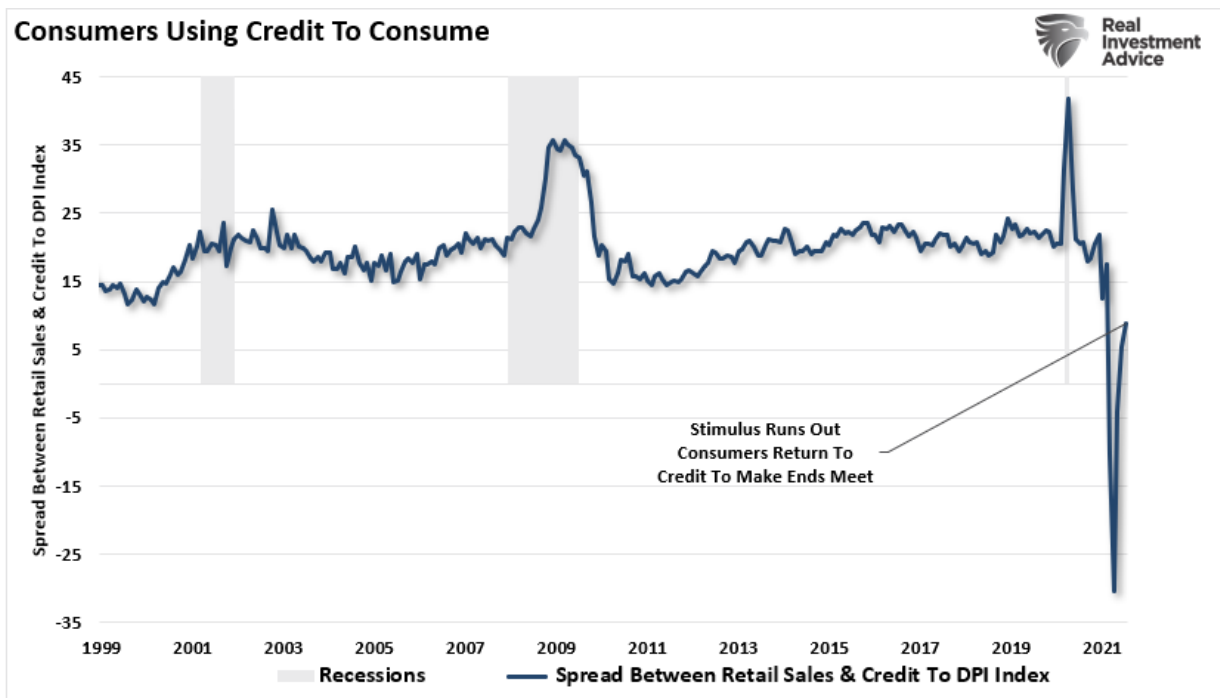
"U.S. consumers are riding to the rescue ? yet again ? by spending with reckless abandon in the face of potentially stagnating growth. August's retail sales�[surprised to the upside](#), and although July's data saw a sharp downward revision, National Retail Federation (NRF) calculations showed that sales have spiked by 12% year-over-year.

It gets better: Through August, the NRF estimates that sales are 15% higher than the comparable year-ago quarter, putting 2021's retail sales on track to grow by double-digits from 2020, to at least \$4.4 trillion. That's unequivocal good news for an economy that's ? powered by consumer spending."

However, there were two big factors feeding into the retail sales number yesterday - seasonal adjustments and "back to school" shopping which was not the case last year at this time. Such is what contributed to the 15% gain over last year's sales. When we view retail sales in total we see that sales growth is rapidly dropping and returning back to previous trends.



These numbers were also influenced by the last remnants of stimulus. Such is why we are now seeing a massive surge in the use of credit to make ends meet.



While the NRF is optimistic, and they always are, the data is likely to disappoint in the months ahead as consumers are faced with higher costs and stagnant incomes.

Three Hot Stocks We Are Watching



Evergrande is Sinking

China's largest real estate developer, Evergrande, is suspending trading in its bonds today but intends to resume trading tomorrow. The rumor is they will not pay interest or repay principal on any of its debt this week. Evergrande, with over \$300 billion in debt, poses risks to the Chinese banking system and many foreign creditors. It is unclear whether the Chinese government will bail out its shareholders. With its stocks and bonds trading down significantly, investors are betting against it.

Michael Pettis ([China Property Slowdown Deepens as Evergrande Hurts Outlook](#)) provides great coverage on the problems in China's property markets driving Evergrande's potential default.

Rising Labor Costs

The table below, courtesy of Goldman Sachs, shows the sensitivity of each sector to rising labor costs. Industrials, which are typically labor-intensive businesses are not surprisingly, the most affected sector. It's also worth noting, as shown at the bottom of the table, smaller companies have twice the EPS sensitivity to labor costs as larger companies.

Exhibit 11: Sector EPS hit from 100 bp acceleration in labor costs

Sector	2021E revenue (bn)	2020 number of employees ('000)	Implied labor costs (bn)	Implied labor costs as % of revenue	2021E EBIT margin	EBIT margin %-ile rank (since 1995)	EPS impact from 100 bp accel. in labor costs
Industrials	\$1,366	4,143	\$274	20 %	12 %	63 %	(1.5)%
Consumer Staples	1,680	4,626	138	8	9	46	(0.9)
Consumer Discretionary	1,904	6,619	180	9	10	77	(0.9)
Utilities	326	344	49	15	NM	NM	(0.9)
Materials	442	745	49	11	19	100	(0.6)
Health Care	2,580	3,017	206	8	13	55	(0.6)
Communication Services	1,174	1,380	152	13	22	81	(0.6)
Real Estate	118	193	13	11	NM	NM	(0.6)
Energy	984	467	48	5	11	66	(0.5)
Financials	1,624	2,724	218	13	NM	NM	(0.5)
Information Technology	1,554	3,320	221	14	30	100	(0.5)
S&P 500	\$13,760	27,582	\$1,550	11 %	17 %	96 %	(0.7)%
Russell 2000	1,909	6,517	297	16	9	66	(1.5)

Source: FactSet, Company filings, Goldman Sachs Global Investment Research

Ferrari's Are Cheap

We finally found a valuation technique that claims stocks are cheap. The graph below compares the earnings yield of the S&P 500 to junk bond yields. **To put this technique into context, it is like saying a Ferrari is cheap when compared to a Lamborghini.** Junk bonds have never been more expensive. Currently, the B-rated, Bank Americal junk bond index yield is 4.44%, about 2% below its average from 2016-2019. It's also worth noting this measure deems stocks as expensive at the market lows of 2001, 2009, and recently in March of 2020.

