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Credit spreads likely to stay at elevated levels

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Structural deleveraging leads to widening of credit spreads onshore and offshore

On 2nd Feb 2018, we published a report "China Macro: Where are we in the financial sector deleveraging process?". In that report, we highlighted that the financial deleveraging process combining an onshore bond maturity wall in 2H18 & 2019 for developers may lead to higher borrowing cost in onshore and offshore credit market. This is happening. While we do expect some marginal policy easing (RRR cuts) in 2H18 to mitigate the impact, we believe the regulators' determination to deleverage, form a credit curve, cool down the property market and force credit to go into the real economy is unchanged. We expect onshore and offshore credit spreads to stay at elevated levels for the rest of 2018. We recommend investors to stick with companies and sectors of manageable debt level, longer debt maturity, strong cash flows, encouraged by policies and have low reliance on shadow credit.

Onshore shadow credit shrinking; onshore bond defaults increasing

Although the finalized New Asset Management Rules with a prolonged grace period till 2020 are not as harsh as the original proposal, overall credit growth has slowed down more quickly than expected. The outstanding Total Social Financing growth slowed down significantly from 12.0% at YE17 to current 10.5%(Figure 1). Bank loan growth has been stable while the growth of trust loans, entrust loans and commercial bills heading to the negative territory (Figure 3). This reflects the regulators' determination of unwinding the financial leverage and financial institutions' voluntary scale-back. The onshore defaults so far concentrated in companies with high leverage, low profitability and weak cash flows, which is not unusual. When credit becomes scarce, weaker ones are the first to feel the pain. We expect this trend to continue for the rest of 2018.

Onshore bonds diverged: risk aversion pushes rates tighter while credit bonds widen

The credit spreads for AA LGFV bonds widened by 92bps since Oct-17 and the credit spreads for AA industrial bonds widened by 75bps. Interestingly, the risk aversion led to demand in the rates market and pushed treasury yield lower since Feb-18 (Figure 7). Some level of re-leverage in the rate market has caused some spikes in interbank rates. The credit spreads for AAA industrial and LGFV bonds did not see severe widening neither.

Offshore bonds: repricing of high yield bonds and unwinding of leverage

Developers and LGFVs are two major groups of borrowers in onshore shadow credit market. Without additional funding from bank loans, they may face increasing refinancing difficulties. The rising UST and unsettling geographical and political scenes have triggered a repricing of the high yield USD bonds in emerging markets (Figure 19). Coupled with the leveraged structure in the bond market, bond investors have turned on a de-risk mode. The gap created by shrinking shadow credit, the delay in approval for onshore developer bonds if persists, may push more developers into offshore credit market, both in public market and in private market. Facing the onshore bond maturity wall, the supply in offshore market may increase. We expect yield to stay at elevated levels.

A tough year for developers: rising financing cost; falling margins

In our recent report "China Property: A Battle for Survivor", we highlighted the increasing market concentration and the battle to maintain the rank in the property market. It is not just in land sourcing that market concentration is increasing – the market concentration for financing is also increasing. SOE and leading non-SOE developers are enjoying much better refinancing channels compared to smaller developers. To recycle cash fast, the developers may accept lower margins with tight price cap policies in Tier 1 and Tier 2 cities.

Unwinding of shadow credit

Overall credit growth slowed more quickly than expected

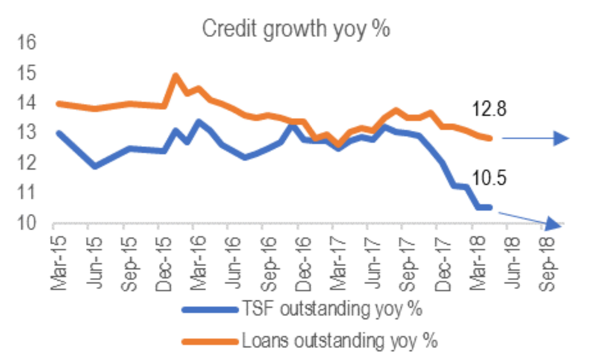
Despite weaker-than-expected New Asset Management Rules, the overall credit growth slowed down more quickly than expected. The outstanding Total Social Financing growth slowed down significantly from 12.0% at YE17 to current 10.5% (Figure 1). Bank loan growth has been stable while the growth of trust loans, entrust loans and commercial bills heading to the negative territory (Figure 3). This reflects the regulators' determination of unwind the financial leverage in the form of shadow credit and financial institutions' voluntary scale-back.

Increasing defaults unavoidable

Onshore bond market started to see increasing default cases as it is transparent (Figure 4). We expect to see some level of deterioration in financial institutions' asset quality, especially for the smaller ones with highest exposures to shadow credit and weakest funding capability. The onshore defaults in the bond market so far concentrated in companies with high leverage, low profitability and weak cash flows, which is not unusual. When credit becomes scarce, weaker ones are the first to feel the pain.

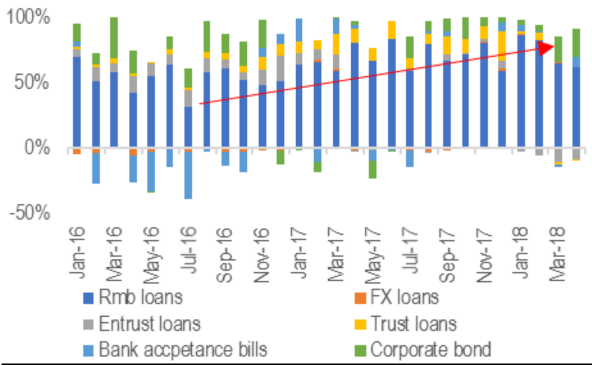
However, we believe the goal is a normalization of credit growth and to force the credit into the real economy. Real estate developers and LGFVs are likely to feel very tight refinancing environment as they are two largest group of borrowers in the shadow credit market. Therefore, their incentive to borrow in offshore bond market is likely to significantly increase in 2018.

Figure 1: Overall credit growth slowed more quickly than expected; loan growth has been relatively stable



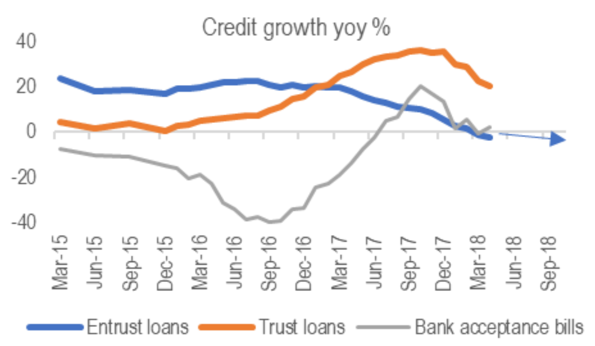
Source: PBOC, WIND

Figure 2: New total social financing mix will shift heavily towards bank loans in 2018



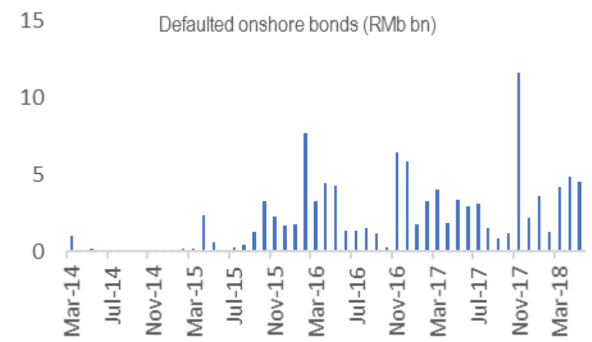
Source: PBOC, WIND

Figure 3: Shadow credit growth fell off a cliff



Source: PBOC, WIND

Figure 4: Monthly onshore bond defaults



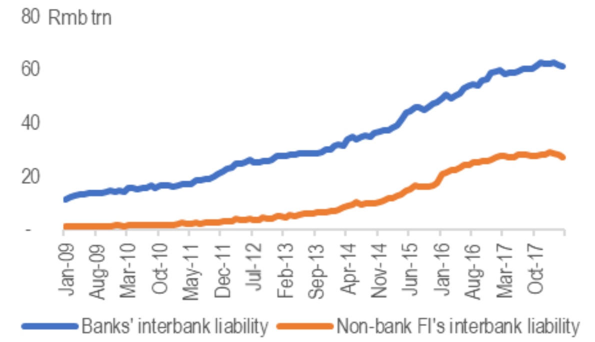
Source: PBOC, WIND

A fast fall in interbank liability

In the past 10 years, with the ongoing financial disintermediation and financial market innovation, the leverage in the financial system has significantly increased – a notable trend was that interbank liability especially for joint-stock banks and regional banks has ballooned. The asset management industry also rises to become the conduit for banks to invest into bond/equity market and non-standard credit assets. As of 1Q18, we estimate financial institutions' interbank liability reached Rmb 90trn (Figure 5), and the big asset management industry AUM reached Rmb 109trn with meaningful funding from commercial banks. This is meaningful compared to total banking system assets of Rmb 250trn.

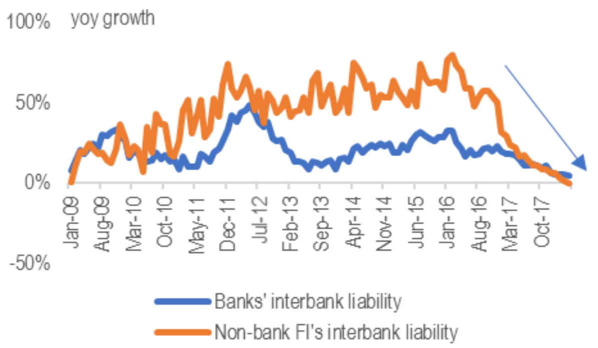
Interbank liability has reached a turning point and the outstanding amount started to fall in April 2018. We believe this deleveraging process will last during 2018-2020 until interbank liability, conduit type of asset management business and non-standard credit have significantly come down. We view this positive for the sustainable growth of China's financial market and it will help improve the capital allocation efficiency. However, short-term pain is unavoidable. We expect to continue seeing more mini liquidity crunches in certain parts of the financial system for the rest of 2018. In addition, joint-stock banks and regional banks may continue to unwind the non-standard credit and may hurt by competition in deposits and a deterioration in asset quality.

Figure 5: Commercial banks and non-bank financial institutions interbank liability ballooned



Source: PBOC; Note: We include bond in interbank liability

Figure 6: Interbank liability growth heading to negative territory



Source: PBOC; Note: We include bond in interbank liability

Where will non-standard credit go?

We believe three ways to digest non-standard credit: 1) switch to loans; 2) switch to bond and ABS; and 3) switch to private equity product. Not all non-standard credit can be switched to other forms of credit.

- Switch to loans: Only a limited portion of non-standard assets can be switched to loans. This approach would still be subject to loan quota guidance and add capital pressure to banks; credit to companies that are in industry not supported by the regulators may be difficult to switch to loans; regional banks' non-standard assets to non-local companies are not able to switch to loans.
- Switch to bond and ABS: Not all non-standard credit can be switched to bond or ABS. This is due to higher requirement by ABS listing rules.
- Switch to asset management products: Non-standard assets can be packed into asset management products that do not provide principal or return guarantee. The new asset management industry rules prohibit duration mismatch which may make it hard for banks to issue short-term wealth management products that is backed by non-standard credit.

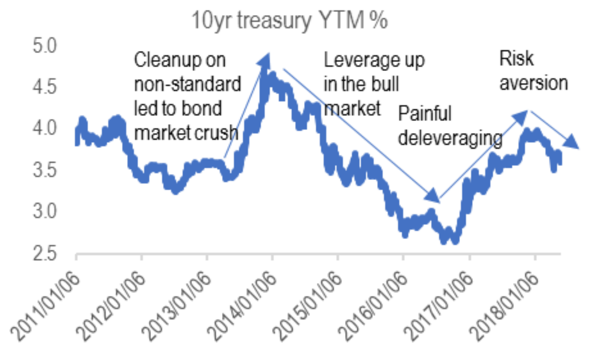
Onshore bond market may see elevated defaults – this may keep credit spreads at elevated levels

Starting in 2016, onshore bond market was the first to feel the pain as it is liquid and where the most leverage lies in. This pushed up overall interest rates in the bond market (Figure 7). Increasing concerns for defaults have triggered a notable widening in credit spreads. In 2H17, the credit spreads started to pick up quickly especially for the AA rating groups. The credit spreads for AA LGFV bonds widened by 92bps since Oct-17 and the credit spreads for AA industrial bonds widened by 75bps.

Risk aversion favors rates and high rating bonds

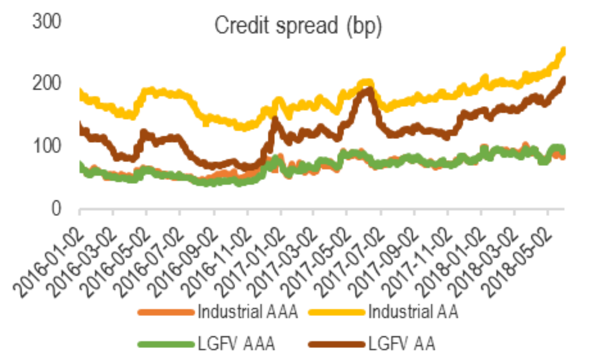
Interestingly, the risk aversion led to demand in the rates market and pushed treasury yield lower since Feb-18 (Figure 7). Some level of re-leverage in the rate market has caused some spikes in interbank rates while overall interbank liquidity is not tight. The credit spread for AAA industrial and LGFV bonds did not see severe widening neither.

Figure 7: Onshore interbank rates shooting up



Source: WIND

Figure 8: China onshore credit spread likely to continue widening – especially the AA rating

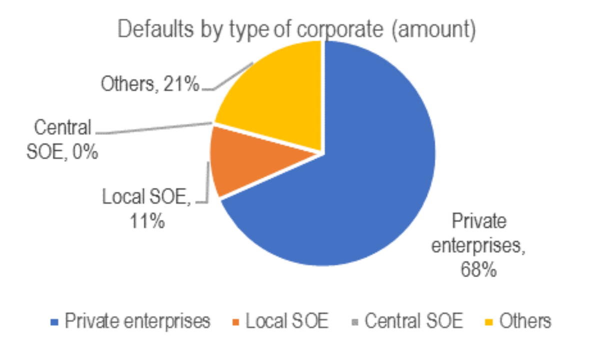


Source: WIND

Onshore bond defaults concentrated in struggling industries

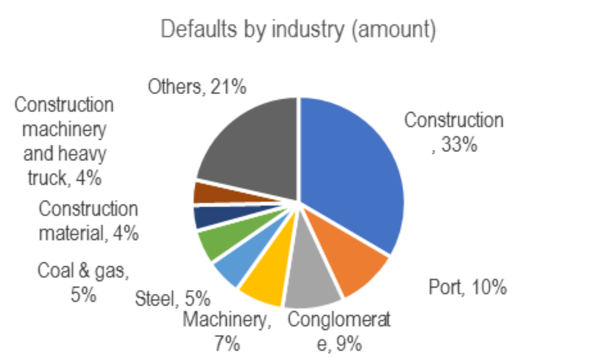
YTD there were 20 default cases with Rmb 18bn of bonds involved. The defaulted issuers have additional outstanding bonds. Private enterprises and local SOEs are two groups with the largest amount of defaults. Industries such as construction and machinery saw the largest amount of defaults, highlighting the difficulties in these industries.

Figure 9: Onshore bond default breakdown by type of corporate （2017-2018）



Source: WIND

Figure 10: Onshore bond default breakdown by industry（2017-2018）



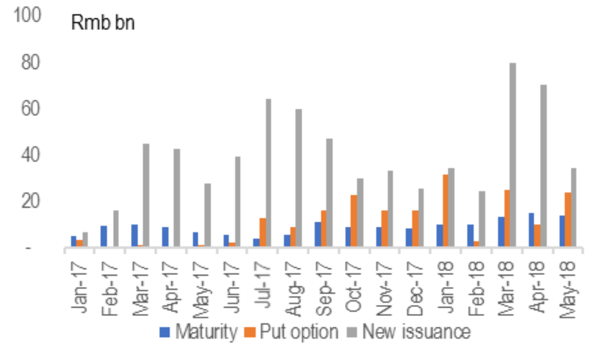
Source: WIND

Developers first resort to onshore bond market then offshore bond market

There has been a notable pickup of new issuance by developers in onshore and offshore bond market but net issuance was flat. In onshore bond market, YTD developers issued Rmb 24.6bn bonds, +78% yoy. This compares to a maturity of Rmb 6.2bn and putable bonds of Rmb 9.4bn (Figure 11). The net issuance was flat yoy at Rmb 8.8bn. After a big jump in net issuance in March and April, in May 2018, the net issuance actually headed towards negative territory. Some news reports suggest there had been some delay in regulatory registration of developer bond issuance, this has triggered concerns by offshore bond investors.

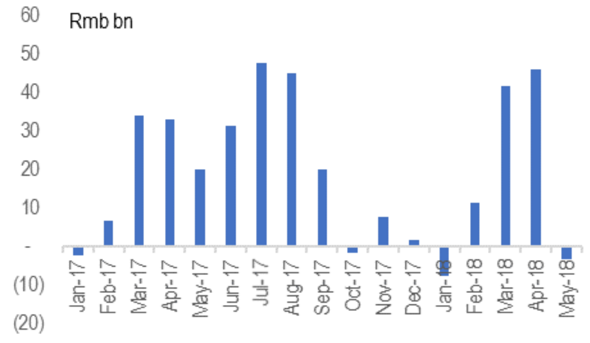
Developers and LGFVs are two major groups of borrowers in onshore shadow credit market. Without additional funding from bank loans, they may face increasing refinancing difficulties. According to news report that there are some delays in onshore developer bond registration, offshore bond market became the last resort. Developer's eager for liquidity has pushed up yield in offshore bond market. Due to the common structure of leveraged notes, the drop in prices has triggered a painful unwinding of leverage in the offshore bond market.

Figure 11: Onshore developer bonds gross issuance in 5M18 reached Rmb 24.6bn, +78% yoy



Source: WIND

Figure 12: Onshore developer bonds net issuance (gross issuance minus maturity and puttable bonds) was Rmb 8.8bn, flat yoy

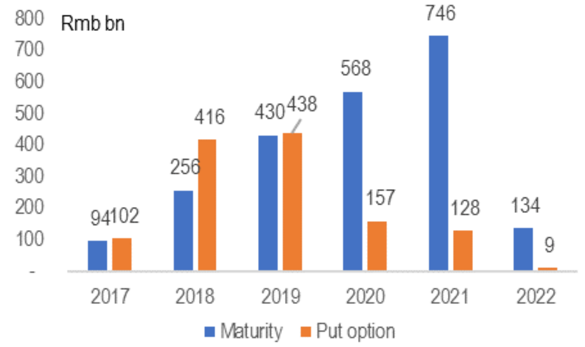


Source: WIND

Maturity wall for developer bonds in 2H18 and 2019

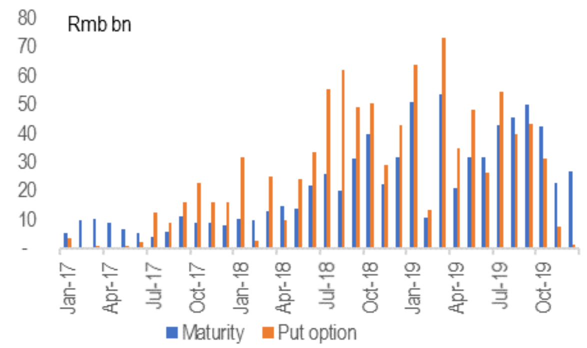
Due to the bull physical market in 2015-2017 and the loosening of onshore bond issuance for developers then, a lot of onshore developer bonds will reach mature or puttable date in 2018-2019. According to WIND data, there are Rmb 256bn of developer bonds maturing in 2018 and Rmb 430bn in 2019. In addition, a historical high of Rmb 416bn of developer bonds will reach puttable date in 2018 and Rmb 438bn in 2019. We remind investors to watch out for high maturity month in 2H18 and early 2019. Some of these developers may find it hard to refinance through the onshore bond market. For developers, their incentive to recycle cash from fast sales will be higher in 2018 despite very tight price cap policy in tier 1 and tier 2 cities. Sector consolidation will intensify. The maturity wall may also push developers to the offshore credit market.

Figure 13: Onshore developer bond will hit maturity and put option wall in 2018-2019



Source: WIND

Figure 14: 2H18 and early 2019 will see large amount of onshore developer bonds mature and reach puttable date

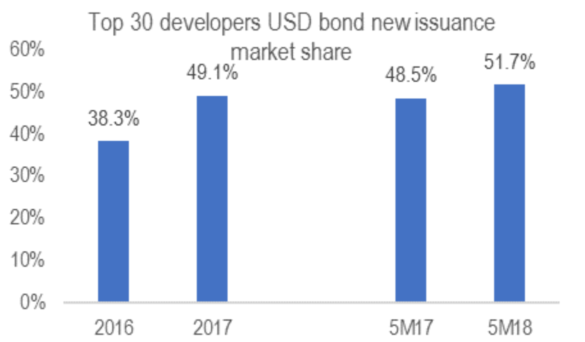


Source: WIND

Market concentration for financing is increasing

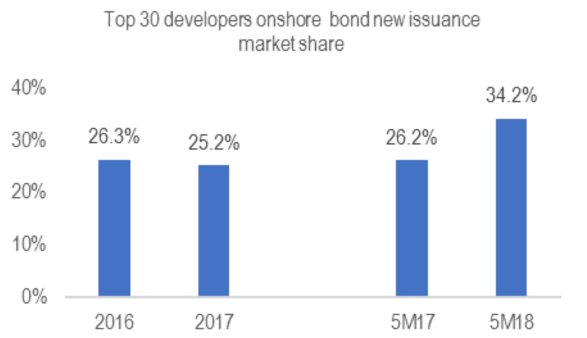
It is not just in land sourcing that market concentration is increasing – the market concentration for financing is also increasing. SOE and leading non-SOE developers are enjoying much better refinancing channels compared to smaller developers.

Figure 15: Top 30 developers' market share in offshore bond market increasing



Source: WIND; Note: We use the top 30 rank in contracted sales in 2017.

Figure 16: Top 30 developers' market share in onshore bond market also increasing



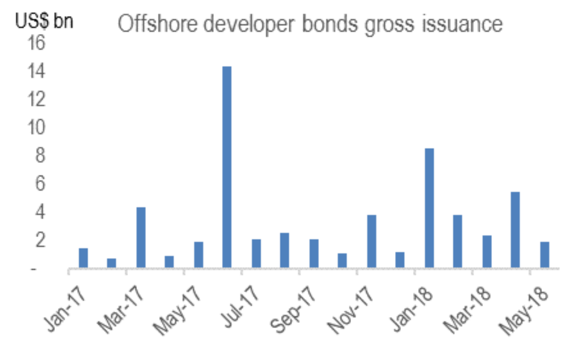
Source: WIND; Note: We use the top 30 rank in contracted sales in 2017.

Offshore bond market repricing

The volatility in offshore high yield bond market may push issuers to private market

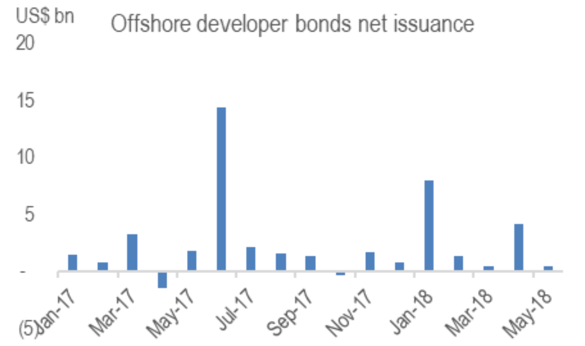
The gap created by shrinking shadow credit, the delay in approval for onshore bonds if persists, may push more developers into the offshore credit market, both in public market and in private market. However, the repricing of public bond market has significantly reduced investors' appetite for high yield issuers. Therefore, in 5M18, the net issuance of USD China developer bonds did not pick up notably. 5M18 net issuance was US$14bn vs US$27bn for the full year of 2017.

Figure 17: Offshore developer bond gross issuance



Source: WIND

Figure 18: Net issuance of offshore developer bonds did not pick up notably



Source: WIND

Repricing of USD high yield bonds make it difficult for new issuance

The rising UST and unsettling geographical and pollical scenes have triggered a repricing of the high yield USD bonds in emerging markets. Coupled with increasingly eager issuers willing to pay for a high premium, investors have turned on the de-risk mode. This triggered a repricing of USD high yield bonds. The iBoxx China USD High Yield Index YTW expanded to current 8.48% from 5.22% in Jan-18. The existence of the leveraged structure in the USD bond market has also put the repricing into a vicious spiral.

It is unclear how much the unwinding of leveraged notes remains and thus it is difficult to estimate their future impact on the bond market. But there is likely to be some over-shooting. We expect the issuers to increase exposures in the private market in 2018.

The maturity wall for onshore developer bonds may increase supply in offshore market

As we mentioned in early section, the maturity wall for onshore developer bonds in 2H18 and 2019 may push the issuers to offshore market. We alert investors of increasing supply risks.

Figure 19: iBoxx China USD High Yield Index YTW

Source: Bloomberg

Figure 20: iBoxx China USD High Yield Index (Total return)

Source: Bloomberg

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