Economics

# DBS Focus

# Risks in China's bond and credit markets

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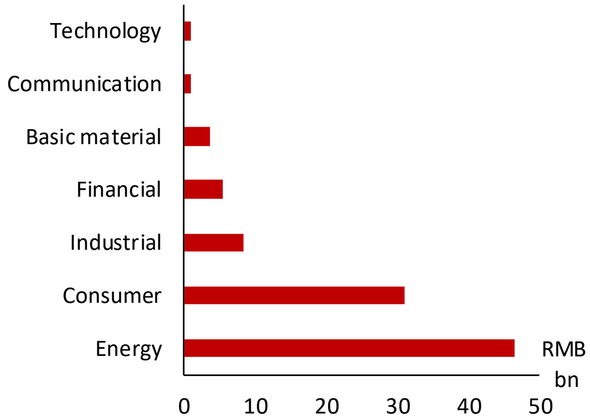
- *Default wave is set to extend into 2019 amid maturing issuance and reduced risk appetite.*
- *The ascent in real interest rates will intensify financial distress, weakening firms' debt repayment ability.*
- *Further monetary stimulus notwithstanding, we think that the bulk of the govvie rally may be behind us.*

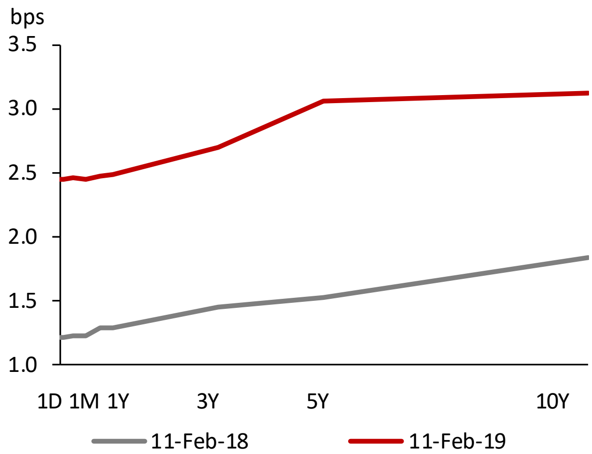

**China witnessed an unprecedented wave of corporate bond defaults last year**, in a fresh sign of wobbles hitting financial markets as slowdown deepens. Delinquencies soared quadruple from 2017 to a record RMB119.6bn. Energy sector recorded the most defaults with RMB46.4bn, followed by consumer companies (Chart 1). By regions, Shanghai topped the list at almost RMB30bn. Shanxi (RMB16.5bn) and Zhejiang (RMB10.3bn) took the second and third spot. Private sector continued to bear the brunt of tighter credit condition, making up 90% of the pool.

**Chart 1: Amount of defaulted bonds**




The default wave is extending into 2019, with two big issuers failing to meet their obligations this month. **Given the reduced risk appetite and huge maturing volume, the outlook is poor,** with RMB3.5tn in corporate bonds due in the next twelve months. Availability of credit for refinancing remains tight despite repeated monetary easing by PBOC. The yield spread between AA- and AAA on five-year notes stood at 306bps on 15 February, more than twice the level a year ago (Chart 2).

**Chart 2: AAA and AA- yield spread**




**Commercial banks have remained cautious in lending to private companies and financially wobbly state-owned enterprises.** The resulting deterioration of corporate cash flow was evident by collapsing M1 growth (Chart 3).

**Chart 3: M1 and M2 growth**

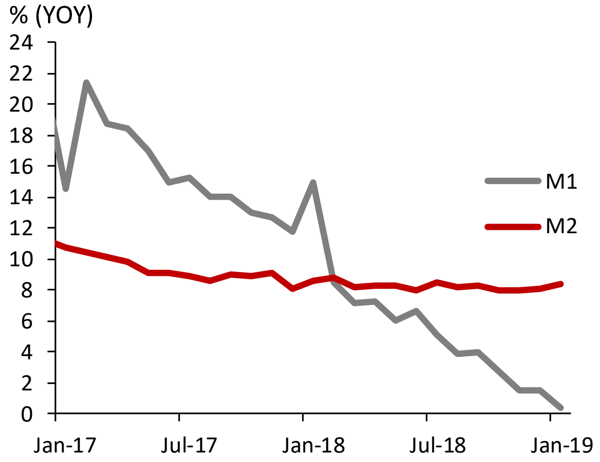
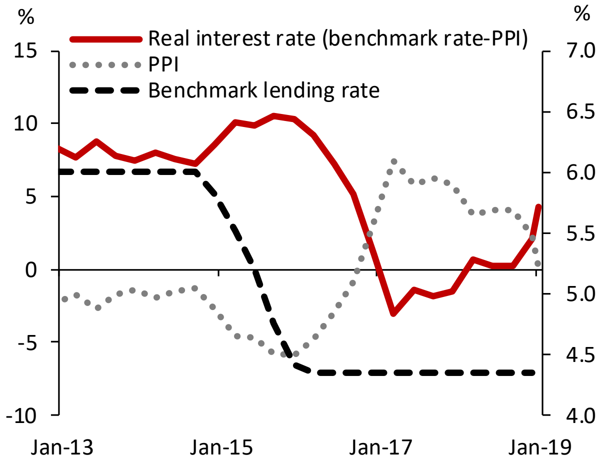



**Chart 4: Interest rates and PPI**



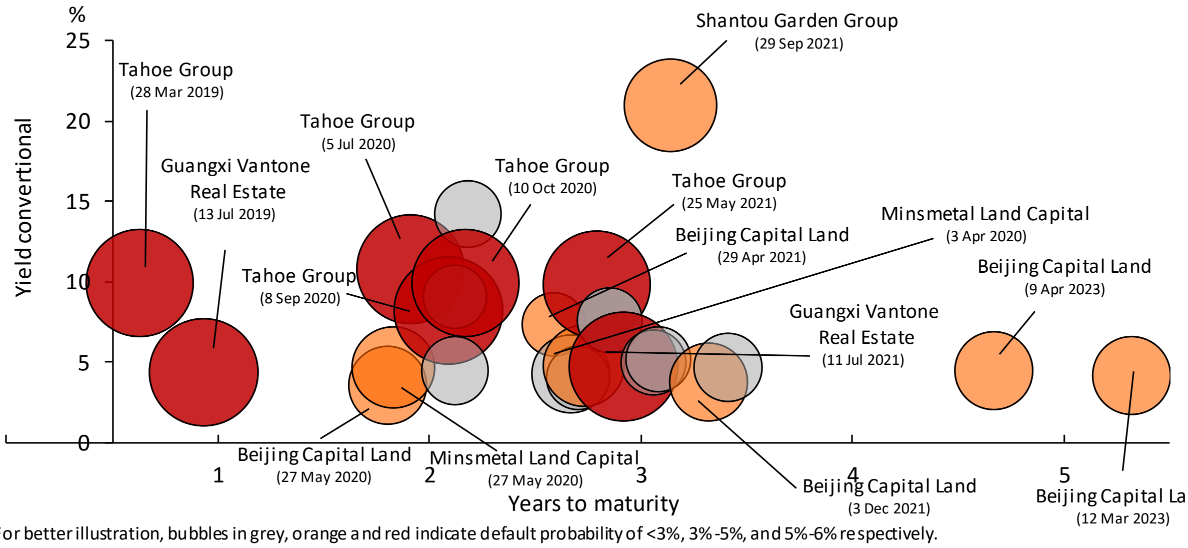

**Aggravating the liquidity strain, real interest rates (benchmark lending rate minus PPI) have shot up to 4.3%** in Jan 2019 from as low as -3.1% in Q1 2017 (Chart 4). The consequential tighter monetary conditions would add to the financial stress on Chinese firms with high leverage and maturity mismatches. That doesn’t bode well for their debt repayment ability.

**The real estate sector is a case in point.** A worryingly large share of recent borrowing has come in the form of short-term bonds. Funding pressure facing property developers have been exacerbated by the housing slowdown. Home sales by floor area rose by a mere 2.2% YoY in 2018, down from 5.3% and 22.4% in 2017 and 2016 respectively. Government ‘s crackdown on shadow lending also heightened builders’ refinancing difficulties.

That explains why **investors are growing jittery about the property sector.** Evergrande, the country’s second-largest developer by sales, sold USD1.025bn in bonds last month maturing in 2022 at a yield of 10.5%. That came after Shenzhen-based builder Fantasia Holding Group Co. sold 2021 bonds at 15% in December. Ominously, the high-yielding real estate bonds usually associate with higher default risk, according to Bloomberg default risk calculator (Chart 5).

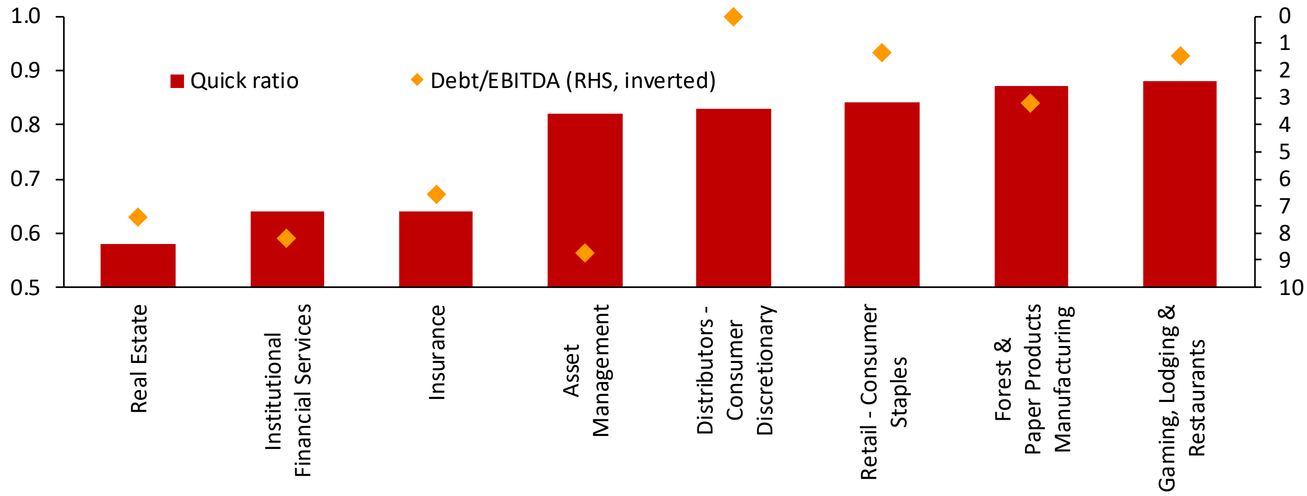
**Chart 5: Real estate bonds (yields and default risks)**

Size of the bubble indicates the 1 year default probability




Note: For better illustration, bubbles in grey, orange and red indicate default probability of <3%, 3%-5%, and 5%-6% respectively. Maturity dates are in brackets.

**Chart 6: Financial health by industry**




Indeed, major barometers including quick ratio and debt/EBITDA point to the sector's poor financial health:

- Quick ratio: On average, property firms' liquid assets only able to cover 58% of their liabilities, the lowest among all industries.
- Debt/EBITDA: Builders' total debt is about 7.3x their earnings before interest, taxes, depreciation and amortization, far higher than the average of 4.7x (Chart 6).

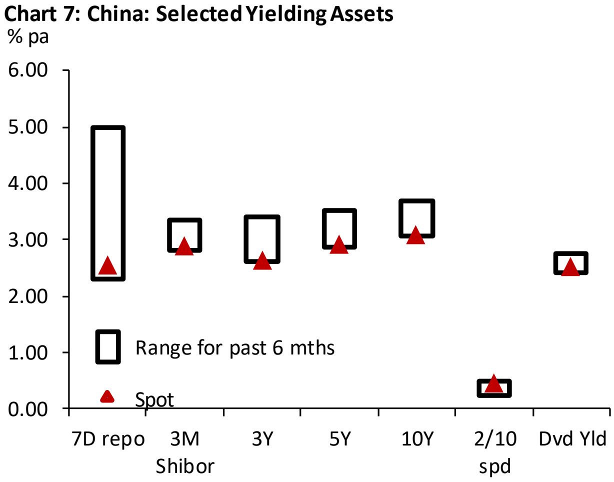
Small steps have been taken at the local level to encourage home buying since December such as lifting price caps and removing re-sale restrictions. In our view regulators could turn to all-round loosening in Q3 to soften the blow from a burgeoning trade war on an already faltering economy. Until then, expect more missed bond payments by Chinese builders.

## Rates: Policy support vs improving sentiment

**Support from the authorities on the monetary policy front is unlikely to abate just yet.** Multiple policies have been announced by the PBoC over the past several quarters as China's economic slowdown starts to bite. We argue that these measures have arrested the worst of financial market strains. Notably, interest rates across all tenors (7D repo to the 10Y govvie yield) are hugging close to their respective six-month lows. **While further corporate defaults appear inevitable, credit spreads have stabilised, and the stock market has staged a nascent rebound** (the CSI 300 is up by 13% ytd) (Chart 7).

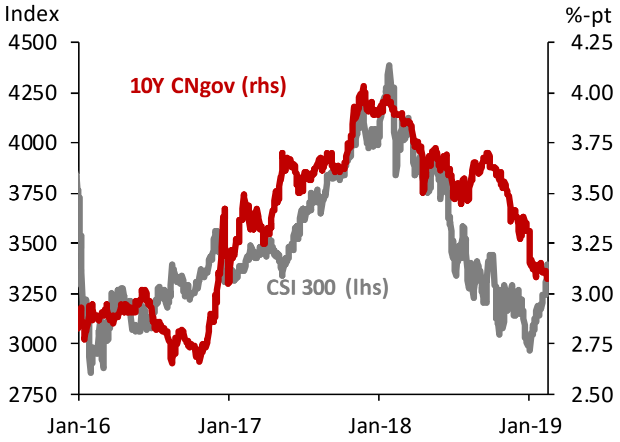
**The govvie rally has been considerable** as the curve bull steepened since early 2018. In fact, the 3Y/10Y segment of the curve looks steep by recent standards and probably accounts for why the curve has been level-shifting lower in more recent months. We think that the bulk of the duration gains may be behind us. As 10Y yields approach 3%, we would turn increasingly cautious. **Along the curve, we think the duration pickup is attractive out to the 7Y tenor** as bets on further monetary easing anchors frontend rates.

**Chart 7: China: Selected Yielding Assets**




**Going long China govvies is looking like a crowded trade** (Chart 8). The reasons have already been well-flagged (economic slowdown, trade war, policy support, credit stress, index inclusion) over the past year. Unless economic conditions deteriorate further, the stock market may offer better risk-reward. We are not convinced that the current positive correlation between bond and stock prices is durable. If sentiment stabilises, the traditional relationship (negative correlation) should re-assert.

**Chart 8: The CSI 300 tends to move in tandem with 10Y govvie yields**




**Sources**: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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