Macro Strategy

DBS Focus

China rates and credit: Unearthing value

Group Research

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- *While the dataflow is largely negative, there remain opportunities in a range of Chinese fixed income assets*
- *The PBoC's responses to faltering growth and tight liquidity have succeeded in reducing financial system stress*
- *From a relative value perspective, corporate credit papers offer some opportunities while China government bonds are starting to look rather expensive after a sharp rally over the past few months*
- *We see opportunities in Chinese credit in the BBB space and BB Chinese property developer bonds but are mindful of downside risks in the lower rated credits.*

Rates: Govvies are beginning to look expensive

China government bonds have had a sharp rally and are starting to look expensive. Accordingly, our strategy for China rates has pivoted. While there could still be a further rally in 10Y govvies, we think that the risk-to-reward may be tilting towards selected credits.

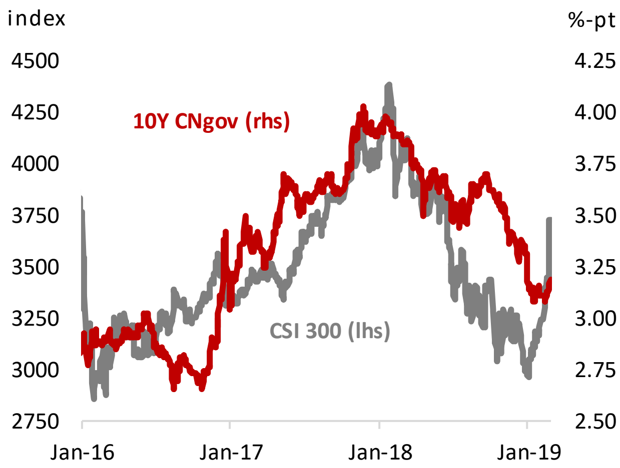
The People's Bank of China's (PBoC) responses to faltering growth and tight liquidity have succeeded in reducing financial system stress. In January, The PBoC cut the reserve requirement ratio (RRR) by 100 bps. Several new innovative tools have also been launched to aid cash-strapped private firms. These include i) the introduction of targeted medium-term lending facility (TMLF), which provides banks cheaper funding to expand their credit support to small and private enterprises; ii) the issuance of perpetual bonds by banks to replenish capital; and iii) the creation of the central bank bills swap, which banks can exchange their holdings of perpetual bonds with PBoC paper.

Monetary policy
Broad-based
4 RRR cuts, amounting to 350 bps in total (Jan, Apr, Jul and Oct 18)
100 bps RR cut (Jan 19)
Targeted
Relending and rediscounting quota increased (Jun, Oct, Dec 18)
Credit support for corporate bond issuance with CRM (announced: Oct 18)
TMLF established (Dec 18)
Others
Scope of collateral of MLFs broadened (Jun 18)
MPA factors adjusted to encourage lending to SMEs (Jun
New AMP introduced to allow more flexibility in unwinding shadow financing (Jul 18)
Perpetual bonds introduced to boost Banks' Tier 1 capital (Jan 19)
Central Bank Bills Swap launched (Jan 19)

Financial conditions have eased. 10Y govvie yields are at 3.17%, down from almost 4% at the start of 2018. Current yield levels are close to those seen at the height of the global financial crisis in 2008/09 and in the period where China hard-landing (and RMB devaluation) fears were at its peak in 2016. Similarly, credit spreads (AA-) have stopped widening, albeit at elevated levels. While support for credit is being pushed out, fears of further defaults have retrained any meaningful credit rally for now. Lastly, while stock markets have had a bounce since the start of 2019, the performance over the past five quarters has been dismal as slowing growth and trade war fears weigh.

Credit growth is showing tentative signs of recovery. Aggregate social financing jumped to RMB 4.64 tn last month, up sharply from RMB3.08tn a year ago. Growth in non-bank credit (corporate bond issuances and shadow financing) has also picked up. While the Lunar New Year has probably distorted these numbers, it should not detract from the fact that credit growth appears to have bottomed. That said, further policy support will probably be needed to support this nascent recovery. Chinese exporters will still be facing headwinds from slowing global demand even if a trade deal is reached between China and the US. Two more RRR reductions are likely this year with a benchmark lending rate cut on the cards if economic conditions deteriorate further.

Will rising stocks put a halt to falling yields?



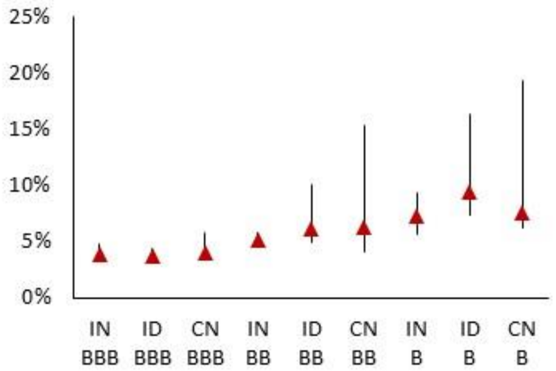
Source: Bloomberg, CEIC, DBS

The divergence between the Chinese stock market (heading up) and govvie yields (going down) is unlikely to be sustained. Monthly correlations show that the CSI 300 and the 10Y govvie yield are negatively correlated as we would expect. Optimism on China-US trade talks have probably lifted equities, but the bond market may need further convincing that the worst is over. To be sure, foreign interest in govvies and unabated monetary policy support suggest that yields will be low by historical standards. However, **we are wary of chasing govvie yields lower after the sizable rally over the past few months and will be watching closely to see if rising stock prices would lift yields and narrow credit spreads.**

Credit: Selective opportunities amidst risk

Within Asian credit, **we see better relative value in the investment grade and selected BB credits in China, relative to India and Indonesia.** This is largely driven by supply, with the absence of meaningful bond supply from Indian and Indonesian issuers resulting in tighter secondary market valuations for the latter. At the same time, we also see a higher risk of credit events in the lower rated (B and below) space in China. This is an area where we would be cautious. This chart below shows the better relative value among Chinese bonds and also the higher risk with single B issuers (reflected in a much wider yield dispersion).

Median yield and dispersion of 3-5Y bonds



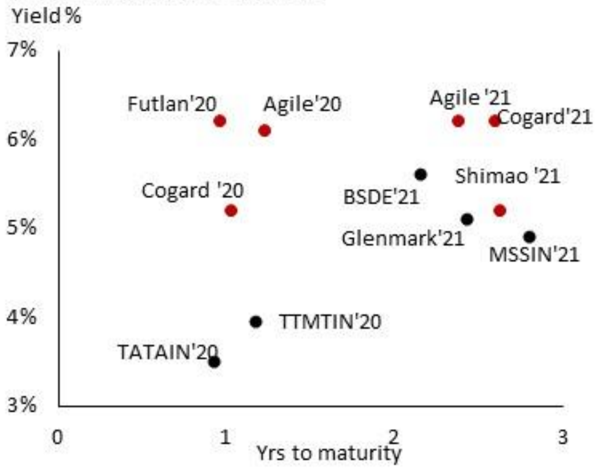
IN=India; ID=Indonesia; CN=China
Source: Bloomberg, DBS

BBB and BB credits offer yield pickup: High grade bond valuations have turned towards the expensive side, in our view, following the rally this year (Macro Strategy dated Feb 1 and Feb 22). While the market's expectation of a patient Fed and easing in trade tensions will remain supportive of valuations, **within the context of overall richness, we see Chinese BBBs as offering some value**. Credit risk in this sector is manageable, especially with credits with strong shareholders (e.g. central SASAC owned companies). Given the expectation of government support, state owned enterprisers have good market access and lower credit risk.

In the BB space, we had picked **short-dated Chinese property developer bonds** as one of our top trades of the year. While valuations have turned less attractive, the rationale of our trade (i.e. yield pick up over comparable Asian BBs still holds). Given the improved market sentiment, lengthening duration slightly (3-4Y) is an option to pick up some yield. We believe default risk for BB issuers should remain low, especially given the loosening of credit conditions by authorities.

Recent developments (towards the end of 2018) include the NDRC's support for onshore bonds rated AAA (local rating) and the introduction of the targeted medium-term lending facility (TMLF). Such measures facilitate flow of credit to private companies and we believe this will be supportive of the credit quality of at least the larger sub-investment grade companies. While the past is not an indicator of the future, we nevertheless draw comfort from the fact that **historical default rates in the property sector have been low**. Since the first Chinese property bond was issued back in 2006, there have been only two incidents of default. Our equity analysts also opine that the asset base and the increase in funding channels, alleviate risk, especially for listed developers.

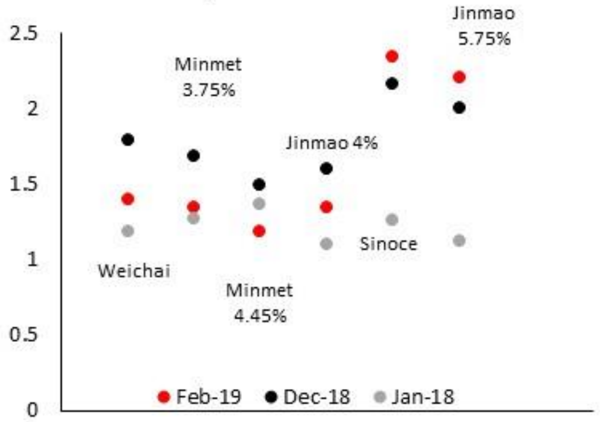
Relative value in Chinese BB



Source: Bloomberg, DBS

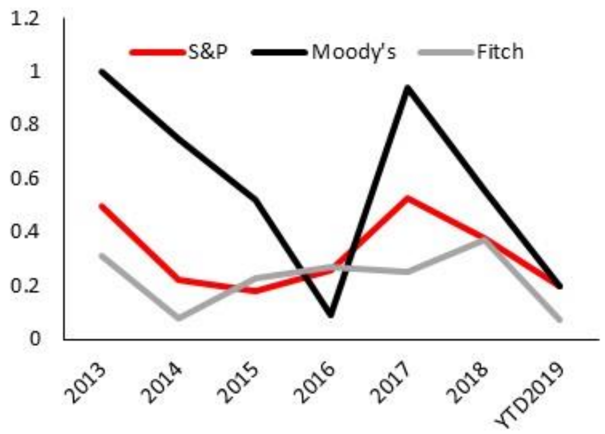
Subordinated bonds: Subordinated bonds of high-grade issuers (capital securities of bonds (Tier 1 and Tier 2) or corporate perpetuals) are another area of value and is a lower-risk alternative for picking up yield rather than going down the credit curve to single Bs. **Sub-senior spread multiples have narrowed since the start of the year but are still higher than what they were at the start of 2018.** For bank capital securities, we do not see a high risk of a non-call (which is a question on investors' minds after the recent decision of Banco Santander not to call one of its capital bonds, Macro Strategy dated 15 February). That said, valuations of Chinese AT1s (or Asian AT1 in general) are less attractive compared to similarly rated European AT1s. However, there are supporting factors (e.g. lower supply, strong PB bid) besides fundamental differences. Chinese banks are among the largest in the world and have strong financial profiles (e.g. capital adequacy in the range of 13%). Asian AT1s also typically do not have a hard write-down trigger unlike the European AT1s. For corporate perpetuals, investors should look at high grade bonds with high coupon step up, which have a higher likelihood of being called.

Sub-senior multiple of Chinese sub-debt



Source: Bloomberg, DBS

Chinese HY - upgrade / downgrade ratio



Source: Bloomberg, DBS

Mind the downside risk: While the Chinese credit space offers selective opportunities, we are still mindful of the downside risk. The large amount of bond redemptions due (estimated around USD70bn of offshore bonds in the rest of 2019 and 2020) imply refinancing and liquidity concerns should increase. Apart from fundamentals, corporate governance is an issue that shows up as defaults at this stage of the credit cycle; rating agencies have highlighted this point in recent months.

The recent rally in lower rated credits against a backdrop of an increase in negative rating action is also a reminder of the need for increased vigilance on lower rated credit exposure. The following chart shows that the upgrade-to-downgrade ratio for Chinese high yield issuers has declined sharply so far this year. While the ratio as such is not abnormally low relative to history (e.g. 2014 and 20016 had similarly low ratios), it does present a risk given credit conditions are tightening and large debt maturities are coming up both onshore and offshore. **The rally in lower rated credits might well be an opportunity to exit weak credits** and move up the credit curve. **Caveat emptor**.

Asian credit performance by rating

Note: Markit clean price
Source: Bloomberg, DBS

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