Economics & Strategy

DBS Flash

Credit: China-driven divergence

Strategy/Credit/Asia

DBS Group Research | August 28, 2019

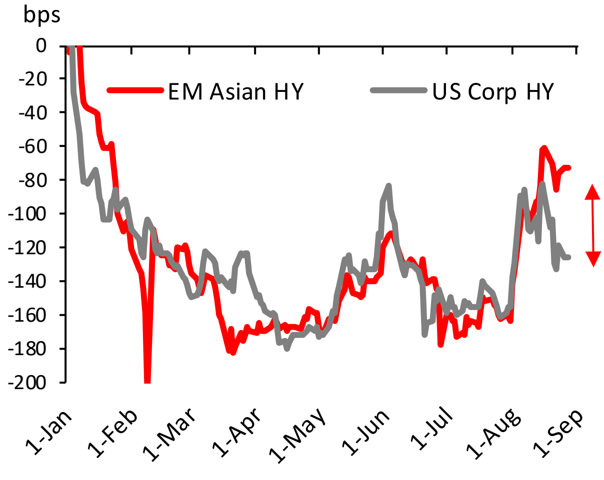
Chang Wei Liang
Macro Strategist (FX and Credit)

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

- *EM Asian high yield spreads remain elevated even as US HY spreads have compressed*
- *Such divergence is at odds with the typical positive correlation between the two spreads*
- *Persistently elevated Asian spreads are reflecting a wider China risk premium*
- *The US-China trade war is only one factor driving China risk perceptions*
- *Higher frequency of Chinese credit distress is largely due to domestic factors, including slowing demand and policy orchestrated deleveraging*
- *A maturity wall faced by Chinese banks is another source of headwind for credit*
- *RMB's recent slide is also raising concerns about Asia's USD debt sustainability*

US and EM Asian HY credits are diverging

EM Asian & US HY spreads (ytd change)



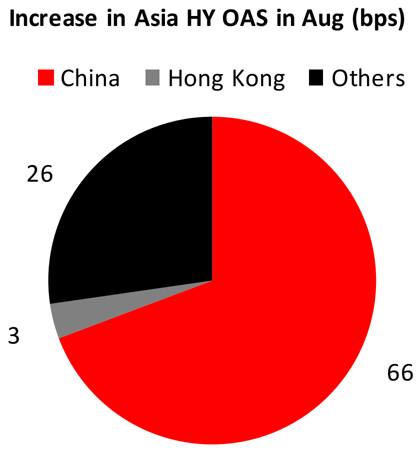
Source: Bloomberg, DBS

Note: USD-denominated, Bloomberg-Barclays Asia credit HY and US Corp HY average option adjusted spreads. Chinese bonds constitute around 60% of the EM Asian HY index (both in number of issuances and market value).

A divergence is occurring within the HY credit space, with EM Asian HY spreads remaining persistently elevated even as their US HY counterparts have narrowed since peaking in mid-August. Such divergence is at odds with our statistical analysis of EM Asia HY against US Corp HY, where we found a significant and positive relationship between both spreads. Our estimates using data from 2015 to mid-2019 show a high sensitivity, where a 100bps decline in US HY spreads typically corresponds to a 55bps decline in Asian HY spreads.

What explains the limited appetite in chasing EM Asian credits even as US HY spreads compress? In one word, China. **Chinese credits have contributed 66bps out of the 95bps increase in Asia's HY spread since end July.**

China risk premium is driving Asian spreads



Source: Bloomberg, DBS

China's outsized economic weight, its high level of centrality within regional trade networks, and its large bond market imply that Chinese developments are key to EM Asian credit markets. **We see four factors driving a higher Chinese risk premium:**

US-China trade war induces downside risks

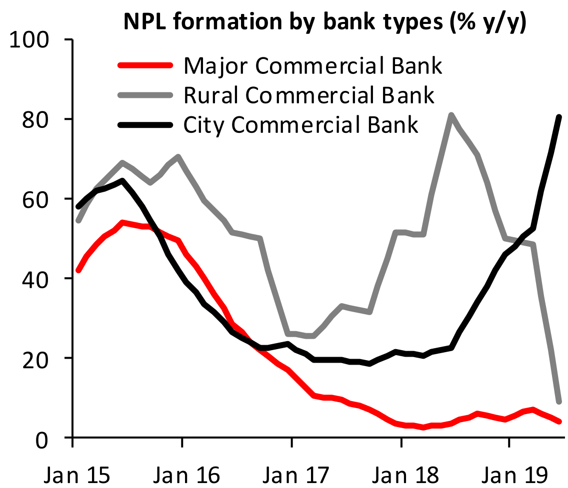
Besides the obvious and adverse direct impact on trade, there are consequential second-order effects to consider from the ongoing China-US trade war. First, there might be reduced business confidence, hampering long-term investment and planning. Second, the diversification of supply chains out of China could prove quite costly in terms of initial set-up costs. Third, businesses might build reserves to guard against tariff uncertainty, instead of increasing wages or investment.

Thus, we see the ongoing trade war as a major factor in driving up Asian risk premiums. Asian-based corporates are clearly facing a more negative outlook for earnings and debt-servicing ability vis-à-vis US counterparts.

Increased frequency of Chinese credit distress

On top of trade tensions, there is also an increased frequency of distress amongst Chinese banks, as demand slows in pockets of China's economy.

NPLs in small city commercial banks have jumped 80% (y/y) in Q2, even as NPL growth in major banks is slowing. Stresses have become more apparent after the state took over a city commercial bank in May this year, which was followed by capital injection into two small banks by state-owned funds and banks.



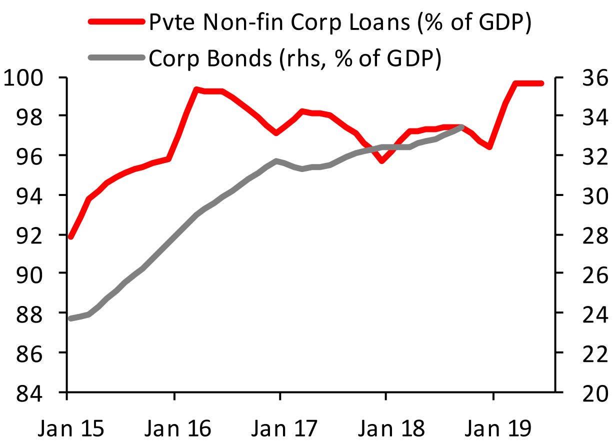
Source: CEIC, DBS

Market doubts about asset quality are limited to smaller (and riskier) banks so far. However, a major Hong Kong-based lender has just announced impairment losses of HKD5.1bn (US$650m), which were attributed to "legacy" commercial property loans in non-Tier 1 Chinese cities. Chinese NPL concerns could thus linger on in the months ahead.

Rising NPLs, viewed from the lens of rapid growth in China's corporate loan and bond liabilities (in comparison to GDP), have two implications.

First, the rollover of maturing debt will be subject to more scrutiny. Second, Chinese corporates are now in a weaker financial position, with debt burdens near record highs.

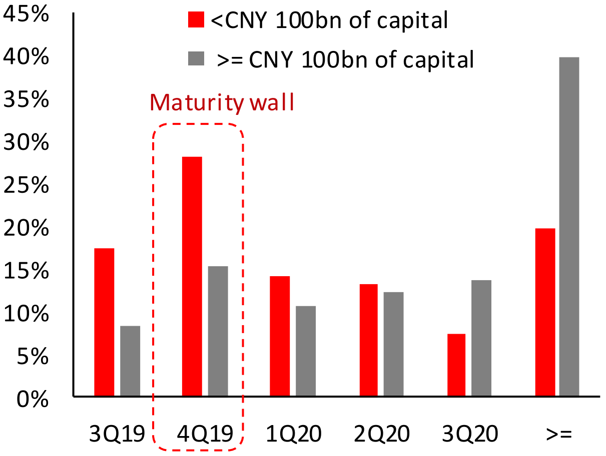
China: Corporate debt has jumped post-2014



Source: CEIC, Bloomberg, DBS

Wall of maturities for smaller Chinese banks

Chinese banks' bond maturities (% of outstanding)



Source: Bloomberg, DBS

Adding to credit concerns, **rollover risks for smaller Chinese banks are also significant as they face a wall of maturities coming in Q4 this year.** Banks with less than CNY100bn of capital will need to refinance 45% of their outstanding bonds soon, unlike larger banks where a significant proportion of maturities are stretched beyond 2020. This implies near-term pressure on Asian HY bonds, where there could be a step-up in yields to secure refinancing.

Weakening of RMB

Finally, a 4% depreciation in the RMB since July has triggered concerns over USD-denominated debt sustainability. Even if China's FX-liabilities are small as a proportion of the country's debt, RMB weakness poses a negative impact on EM Asian HY spreads. The RMB's outsized influence on Asian currencies, which tend to rise and fall with the RMB, could explain this dynamic.

China-resident Private Debt Issuers

As of Q4 2018	Amt (US$bn)	% of total
Total Private Debt Securities	7924	
Private Domestic Debt Securities	7680	96.9
Private Intl Debt Securities	218	2.8
- of which FX-denominated	187	2.4

Source: BIS, DBS

Turnaround still awaited

The authorities have been taking interest rate liberalization measures, which should result in lower lending rates over time. The Loan Prime rate (LP 1y, LP 5y), which is set by a panel of banks, was introduced on 20 August as the new lending benchmark. Loan rates should begin to reflect market conditions more and become less policy-dictated over time.

For now, the pace of change is too slow to stoke a turnaround in Asian credit. The inaugural 1Y LP rate (4.25%) came in at only 6bps lower than the previous 1Y Benchmark Lending Rate, disappointing hopes of sharper lending rate cuts. Measured easing is unlikely to whet credit risk appetite as much as previous big-bang fiscal efforts. More forceful policy catalysts are still needed for the Asian HY credit market to converge with the US market, in our view.

Group Research

Economics & Strategy Team

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Chang Wei Liang
Strategist
+65 6878-2072 weiliangchang@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21-2988-4003 masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist – Eurozone, India & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Duncan Tan
FX & Rates Strategist - ASEAN
+65 6878-2140 duncantan@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

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