Macro Strategy

DBS Focus

High Noon for distressed Chinese credit

Strategy/Credit/China

DBS Group Research

September 17, 2019

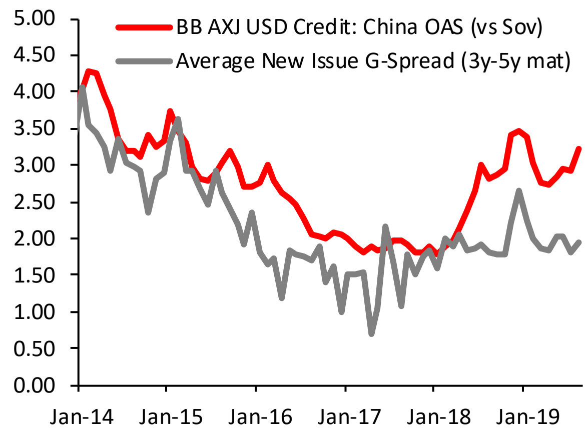
Chang Wei Liang
Macro Strategist (FX and Credit)

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

- *Chinese credit spreads have been on an upward trajectory since 2017 lows.*
- *A global retreat from the search for yield has contributed, but China-specific risks are coming to the fore.*
- *China's structural slowdown, the trade war, and a decline in corporate profitability have all induced financial stresses in the corporate sector.*
- *A coming wall of maturities for distressed credit in 2020 is likely to stir concerns given challenging conditions for rollovers and limited time for a financial turnaround.*
- *2020 could thus mark High Noon for Chinese defaults, surpassing the 2018 experience.*
- *Without state-linked support, onshore monetary easing alone is unlikely to trigger a broad narrowing of Chinese credit spreads.*

Chinese credit spreads are still on the up

China: G-spreads (Offshore USD vs Onshore CNY)



Source: Bloomberg, DBS

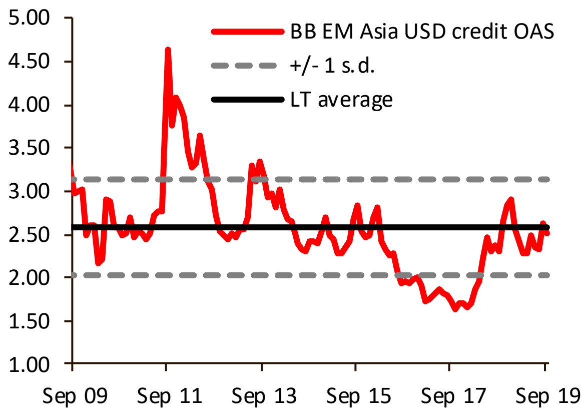
Note: USD-denominated, Bloomberg-Barclays China credit index average option adjusted spread vs average newly issued onshore China non-bank corporate spreads.

Spreads in the Chinese USD credit markets are still on an upward trajectory that started in early 2018. The onshore RMB credit market has also seen an increase in new issue spreads. We think a mix of factors is driving the widening in Chinese spreads, namely **a global retreat from an overt search for yield, Chinese-specific macro risks, and a rising incidence of Chinese credit events.** Stresses are unlikely to peak until 2020, which could mark High Noon for distressed Chinese credits.

Normalization from the global search for yield

While Chinese credit spreads were compressing significantly in 2017, global credit spreads, including those of regional and American corporates, were also easing to decade lows. **In hindsight, credit pricing was exuberant then, reflecting a keen global search for yield.** This laid the ground for global spreads to widen again when risk appetite normalizes.

Bloomberg Barclays EM Asia USD credit average OAS

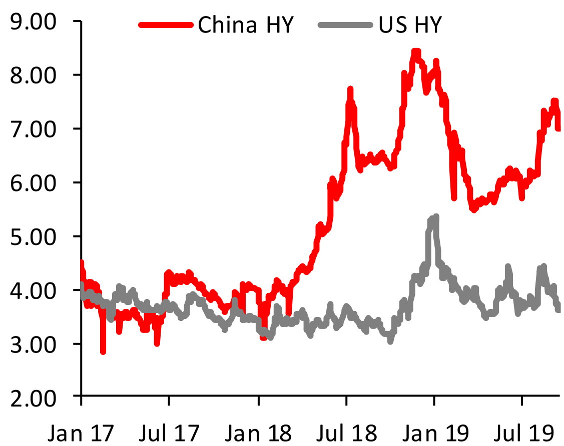


Source: Bloomberg, DBS

Our Asian benchmark, the Bloomberg Barclays EM Asia USD credit index, witnessed a compression in its option-adjusted spread (OAS) to over 1 standard deviation below its decade-average back in 2017. US corporate spreads tell a similar story, as Corp IG and HY spreads narrowed to decade-lows at the same time. **The subsequent normalization of global credit conditions was thus one factor behind the expansion of Chinese spreads since 2018.**

Chinese-specific macro risks have risen

Bloomberg Barclays Corporate HY OAS (%)

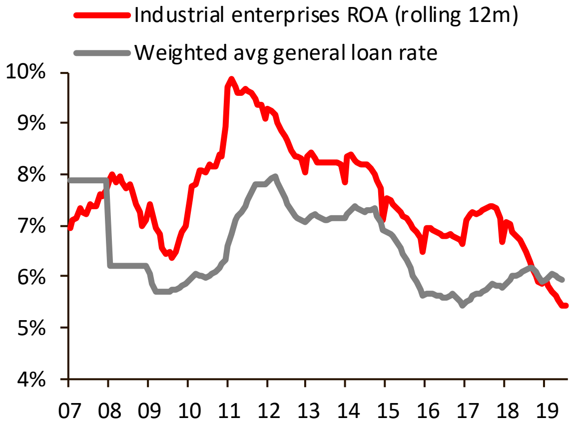


Source: Bloomberg, DBS

Besides global factors, China-specific risks have also grown to become prominent drivers of credit spreads. This is reflected in the diverging performance of risk sensitive HY spreads for Chinese and US corporates, with US credits holding up far better than Chinese counterparts. The additional Chinese HY credit premium has widened from negligible levels to 300bps above US HY, based on Bloomberg Barclays credit indices.

Undoubtedly, the eruption of US-China trade tensions posed a negative surprise and has soured investor sentiment towards Chinese credit. **Another equally important, and often underemphasized, factor was a deterioration in Chinese structural growth**. Sharply increased Chinese private debt burdens, curbs on shadow banking, and negative demographics trends all implies a medium-term slowdown, even if there is no trade war.

China: Industrial enterprises' ROA vs avg loan rate



Source: Bloomberg, DBS

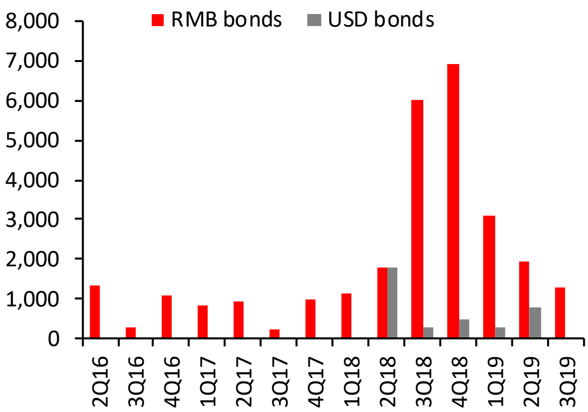
Can Chinese corporate vulnerabilities flare up with a nominal growth slowdown? Notably, the 2015/16 slowdown did not trigger a widening of Chinese credit spreads then. **But now, Chinese industrial enterprises are witnessing a far lower return of assets (ROA) than in 2015—**

with 12M ROA even undershooting the 2009 GFC trough. As asset returns break below lending rates (on average), we think Chinese corporate financial stresses are slated to become more prevalent than in 2015, with asset disposals also likely to step up. These developments should lift credit risk premia broadly across Chinese issuers.

Rising incidence of Chinese defaults

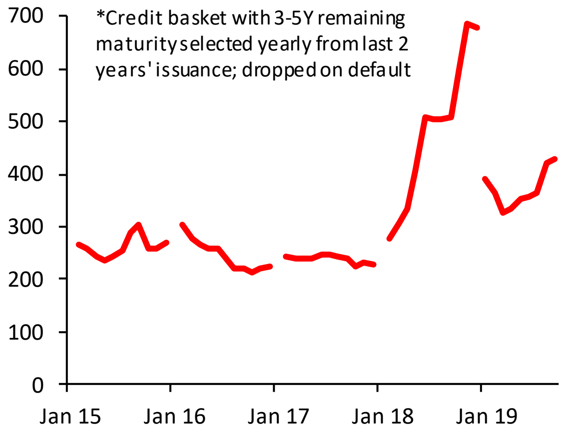
Increased Chinese financial stresses have resulted in a rise in the number of credit events, including delays in coupon payments and outright defaults. Chinese credit delivered a significant shock to investors in 2018, with the number of Chinese defaults in the first three quarters exceeding the cumulative total in the prior 4 years. While most defaults occurred onshore, the offshore USD credit market has also registered a wave of defaults, totalling over USD3.8bn from 2Q 2018 till today.

China Corp Bonds: Defaults in notional amt (USDm)



Source: Bloomberg, DBS

China: Offshore USD non-bank corp g-spread (bps)



Source: Bloomberg, DBS

Rising incidence of defaults in turn precipitated a sharp sell-off in Chinese credit. From 2015-2017, newly issued credits have spreads that mostly trade within a narrow range. However, 2018 saw its basket of newly issued credits (3-5y maturity) recording a 400bps surge in spreads. Higher credit premiums have lingered for the 2019 credit basket too, which has above-average spreads.

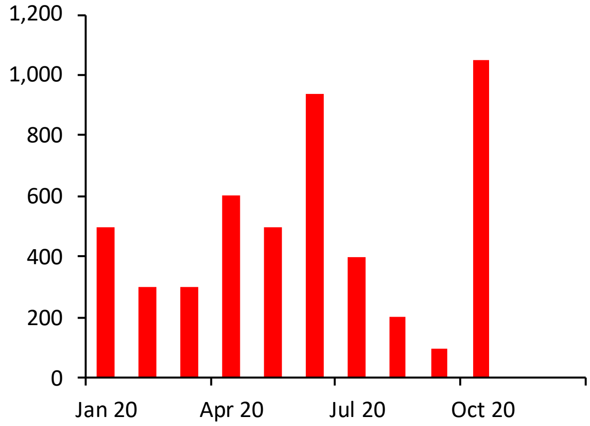
Current prices indicate a significant deterioration in the credit quality of the 2018 basket (issued in 2016/2017). Indeed, USD1.4bn of these credits (1.5% of the basket) have already defaulted due to cross-defaults, even though none were due to mature until 2020. **As credits in this distressed basket approaches their maturities starting next year, could there be another spike in defaults?** Market pricing shows little optimism.

Distressed debt faces 2020 wall of maturities

One market-based estimate of the risk of default is to compare the discount of a bond nearing maturity to its face value. More accurately, one compares the bond price to the price of a US Treasury with equivalent tenor.

Out of a total of 150 offshore USD issuers in the selected 2018 basket, four are in default already. Another 17 of the issuers have bonds trading at over 15% discount to equivalent Treasuries, which we take as indicating distress. **In total, these distressed bonds stand at USD6.5bn in nominal terms**—6 times the cumulative offshore defaults that had occurred year-to-date, and over twice the amount of defaults in a severely stressed 2018.

China: Distressed Bonds' Maturities Amt (USD m)



Source: Bloomberg, DBS

Much of these distressed credits are due rather soon, with over 75% maturing in 2020. Specifically, USD1.10bn of these bonds will mature in Q1, followed by another USD2.04bn in Q2. With the coming wall of maturities, 2020 should mark High Noon for distressed Chinese credit.

Given the high premiums being demanded by the market now, and the short runway for finances to turn around before maturity, refinancing for these Chinese issuers look either impossible or prohibitively expensive without support.

As such, **several issuers may well fail to roll over maturing bonds, which could result in offshore defaults surpassing previous highs** in both quantum and issuers.

Policy support beyond easing needed to lift

Thus far, policy support from the Chinese authorities has leaned towards monetary easing. The PBoC has just enacted a 50bps cut to banks' RRR this month, with an additional 100bps RRR cut for qualified city commercial banks. The Loan Prime rate is also expected to be lowered in the coming months, inducing further relief for indebted Chinese companies.

Even if policy easing and increased liquidity onshore proves supportive for RMB credits, we see no direct lift for offshore USD-denominated credits. Easier financing onshore alleviates repayment stresses only indirectly, as weak balance sheets remain a deterrent for investors in distressed credit, on top of a softening growth environment in China.

Of course, provincial and local governments, or state-owned funds, could provide funds or credit guarantees, particularly for state-linked entities. However, prospects of support are not likely to be broad-based. **As such, Chinese offshore credit spreads are slated to remain wide due to a daunting outlook from a large pool of distressed credit, on top of diminished industrial profitability.**

Group Research

Economics & Macro Strategy

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

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

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

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

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

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

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

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

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

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

Duncan Tan
FX and Rates Strategist - Asean
+65 6878-2140 duncantan@dbs.com

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