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Chinese manufacturers in focus: seeking to steer through macroeconomic headwinds with policy support

by NUS-CRI Market Monitoring Team

- **NUS-CRI Agg PD for Chinese manufacturers fell thanks to the increased overseas demand and optimized debt structure**
- **NUS-CRI Forward PD for Chinese manufacturers suggests the risk of unsustainable demand recovery and negative impacts from the struggling financial sector**

China's manufacturing sector holds a pivotal role in the world economy, making a substantial impact on global GDP. However, in the current year, China's economy faces challenges in achieving a robust recovery after the pandemic. Factors such as a worsening situation in the real estate market, the risks associated with local government debt, sluggish demand, and rising geopolitical tensions are impeding progress. However, despite the numerous headwinds faced, the Chinese manufacturing sector has managed to realize an improvement in credit health over the past 12 months, as exhibited by the decline in the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) below the BB+ upper bound in Figure 1a. A sector-wise breakdown shows an improvement in the credit health of all major manufacturing industries (see Figure 1b), notably, China's automotive sector exhibits the most improvement buoyed by the rapid growth within the electric vehicle segment.

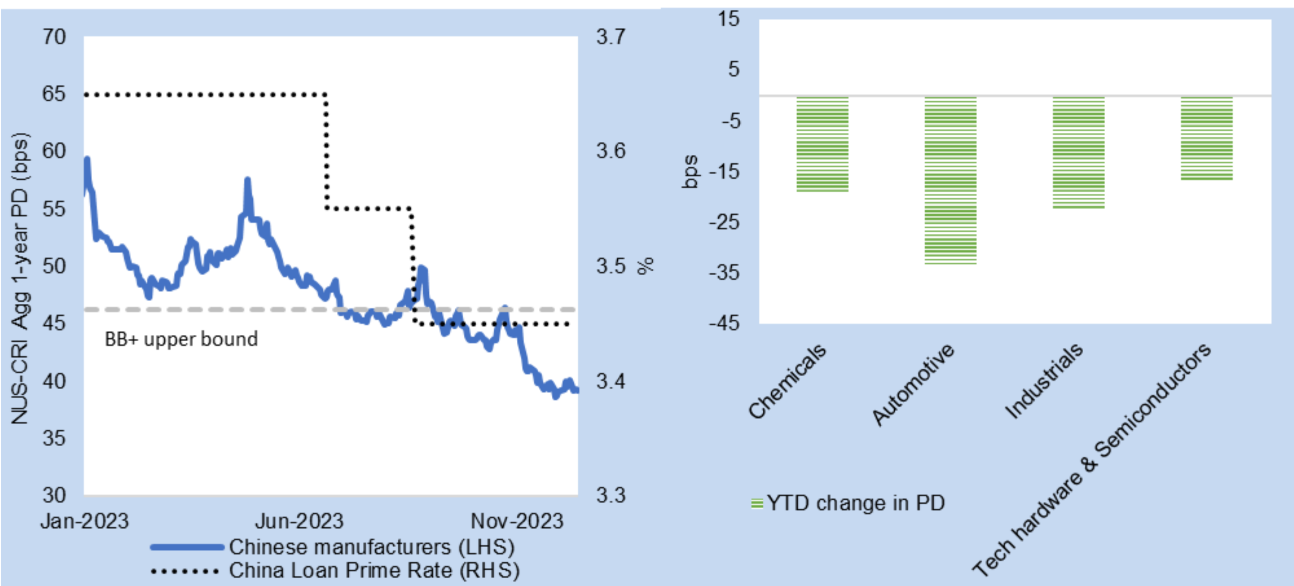

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for Chinese manufacturers, with reference to PDiR2.0 bounds[1], and the China loan prime rate. Figure 1b (RHS): YTD change in NUS-CRI Agg (median) 1-year PD for major manufacturing industries. *Source: NUS-CRI, Bloomberg*

Although China's official manufacturing Purchasing Managers' Index (PMI) remained nearly unchanged in Nov-2023, the Caixin Global Manufacturing PMI, which places more emphasis on export-oriented enterprises and small and medium-sized enterprises (SMEs), reached its highest level at 50.7 since Aug-2023. This increase is attributed to the spike in overseas demand preceding the holiday season. Notably, China's exports experienced MoM growth for the first time in the past six months, despite sluggish domestic demand. The growing influx of new orders and an upswing in positive market sentiment are contributing to the recovery of the manufacturing sector, aligning with Beijing's recent efforts to stimulate the economy. Zooming into the major industries within the manufacturing sector, the automotive manufacturers' credit quality has improved the most during the past year. The Chinese automakers, especially EV makers, have been gaining market share both domestically and overseas post-pandemic, leading to notable enhancements in their revenue and profitability. The tech hardware

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

& semiconductors manufacturers, boasting the lowest median PD among all major sub-industries, have experienced significant improvement in credit quality thanks to robust policy support. The balance of loans to small and medium-sized technology companies rose 22.6% YoY, providing crucial support to the development of the tech industry.

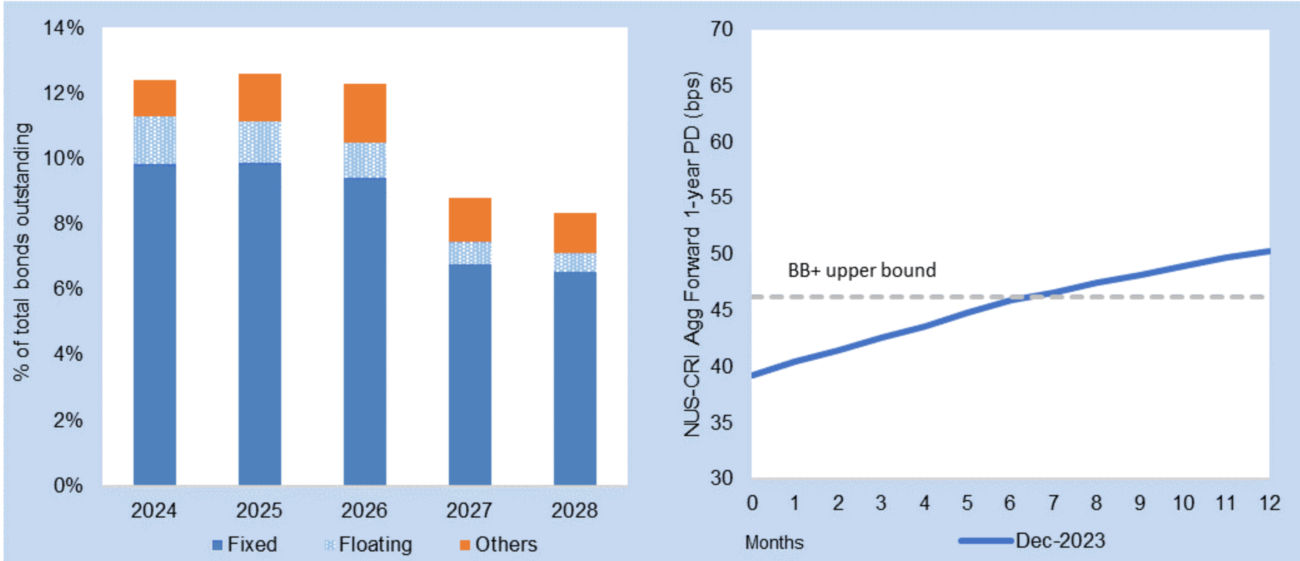

Figure 2a (LHS): Proportion of total bonds outstanding, broken down by coupon types; Figure 2b (RHS): NUS-CRI Agg (median) Forward 1-year PD for Chinese manufacturers as of Dec 2023, with reference to PDiR2.0 bounds. *Source: Bloomberg, NUS-CRI*

Concurrently, manufacturers, unlike financial firms that are grappling with macroeconomic challenges and financing hurdles, have enjoyed the benefits of favorable financial policies. Both the Chinese central and local governments have been directing financial institutions to enhance support for the real economy, including reducing credit costs and extending long-term credit lines. Illustrated in Figure 1a, the loan prime rate has consistently decreased over the past year, lowering borrowers' financing costs but potentially compressing banks' profit margins. By the third quarter of 2023, the balance of loans for the manufacturing sector increased by 17.18% YoY. Notably, there was a significant 38.2% YoY expansion in the balance of medium and long-term loans supporting the manufacturing sector. Consequently, the capital structure of manufacturers has been further optimized, with the debt proportion of long-term bonds (maturity >5 yrs.) reaching 45.6%. (See Figure 2a) Moreover, nearly 80% of the maturing bonds are fixed-rate debt, providing manufacturers with more predictable and manageable financing costs. As the global rate hike cycle gradually concludes and domestic policy support continues, the prospect of declining refinancing costs is likely.

Over the next 12 months, the primary concern for Chinese manufacturers revolves around the sustainability of demand momentum. The current uptick in demand is largely propelled by the year-end surge in overseas orders, a trend that may prove to be unsustainable. If domestic demand remains lackluster, the credit outlook for Chinese manufacturers could deteriorate, as evidenced by the rising NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) shown in Figure 2b. While government-backed financial support has aided with development and enhanced credit health in the manufacturing sector, the challenges faced by banks and other financial firms could potentially generate negative spillover effects for non-financial sectors over the long term. Presently, the PD trends in the financial sector and the manufacturing industry diverge[3], which might be evidence of the distinctions in policy guidance or support. The threatened credit outlook of the Chinese banks also introduces uncertainty regarding the stability of their financing support to manufacturers, probably contributing to the escalation of the Forward PD. It underscores the importance of closely monitoring and addressing potential interdependencies between the financial and non-financial sectors to safeguard against broader economic repercussions.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

[3] For more details, refer to our reports on Chinese real estate and Chinese banks.

Credit News

Foreign investors boost Asian bond buys in November amid US rate cut signals

Dec 13. In Nov-2023, foreign investment in key Asian bond markets surged, marking the most substantial net purchase since May. Investors bought USD 6.36bn in bonds from South Korea, India, Malaysia, Indonesia, and Thailand. This spike was influenced by falling U.S. Treasury yields and anticipations of Federal Reserve rate cuts, following less aggressive comments from Fed officials and lower-than-expected U.S. inflation data. Indian bonds drew USD 1.78bn, the highest since Aug-2017, boosted by positive growth forecasts and their upcoming inclusion in JP Morgan's emerging market debt index. South Korean bonds, benefiting from strong exports indicating economic resilience, experienced their first net gain in four months at USD 1.72bn. The growth in exports across China, Taiwan, and other regional economies also raised expectations of an economic rebound. (Reuters)

China cash squeeze a boon for foreigners snapping up bank bonds

Dec 15. In the midst of many international investors withdrawing from China's bond market, a minority are capitalizing on the opportunity, utilizing favorable exchange rates to develop a profitable trading strategy in short-term bank securities. These investors focus on negotiable certificates of deposit (NCDs) – short-term bank bonds with a maturity of up to a year. They benefit from the premium received when exchanging US dollars for yuan in China's domestic market. This approach has become so appealing that foreign holdings in NCDs surged by 80% to a record USD 40.5bn in the first ten months of 2023, contrasting sharply with a 9% decrease in foreign holdings of Chinese sovereign bonds. (Bloomberg)

Banks struggled with higher rates, but they might come to miss them

Dec 15. In 2023, U.S. banks faced challenges from increased interest rates, which simultaneously raised deposit costs and reduced bond portfolio values, causing some regional bank failures. Despite the KBW Nasdaq Bank index's underperformance relative to the S&P 500, the sector saw a nearly 12% rise in net income year-over-year, with return on equity reaching over 13% for the first time in nearly two decades. This profitability was driven by higher interest earnings from cash reserves and variable-rate loans. However, as the Federal Reserve hints at potential rate cuts, the future earnings from these interests might decrease. Lower rates could also help banks by reducing unrealized losses on securities, possibly leading to more share buybacks and easing upcoming capital requirement pressures. (Bloomberg)

Europe real estate facing EUR 176 bn debt refinance shortfall

Dec 13. Europe is facing a looming crisis in real estate debt, with CBRE Group Inc. reporting a potential shortfall in refinancing EUR 640bn worth of loans maturing between 2024 and 2027. The gap could reach EUR 176bn, driven by declining property values and tighter, costlier credit conditions. Banks, grappling with depreciating assets and increasing risky property loans, have become more cautious in lending. Office buildings are most at risk, comprising nearly half of the expected shortfall, while retail, particularly high-street stores, also faces significant challenges. However, if interest rates stabilize and central banks cut rates as anticipated, this refinancing gap might reduce by about 35%. (Bloomberg)

Pemex's failure to pay debts threatens suppliers' survival, industry warns

Dec 16. Pemex, the Mexican state energy company, is facing significant financial challenges due to its substantial debts to oil service providers and private crude and gas producers, raising concerns about the potential impact on production, investment, and the viability of its suppliers. With financial debt exceeding USD 105bn, Pemex also owes about 17.22bn to both local and foreign companies. Industry group Amexhi, representing these companies, has alerted the government in a letter about the severe consequences of Pemex's payment delays, including jeopardizing ongoing projects and the survival of some firms. (Reuters)

Poor countries' debt costs to hit 'crisis' levels, says World Bank (FT)

Sri Lanka, Bangladesh clinch final approval for IMF loan payouts (Bloomberg)

Ethiopian eurobond surges as investors await bondholder call (Bloomberg)

Regulatory Updates

Fed prepares to shift to rate cuts in 2024 as inflation eases

Dec 14. The Federal Reserve is adjusting its approach, moving from the largest interest rate increases in decades to a potential series of reductions next year. Federal Reserve Chair Jerome Powell has expressed willingness to reinstate rate hikes if inflationary pressures reemerge. However, current forecasts predominantly anticipate rate cuts. Recently, the Fed unanimously agreed to keep the benchmark federal funds rate between 5.25% and 5.5%, the highest since 2001. Powell's comments, which deviated from his previous hesitance to discuss rate cuts, have contributed to a substantial rise in Treasury bonds and pushed the Dow Jones Industrial Average to a new peak. (Bloomberg)

Japan's central bank to sit tight on policy, may drop hints on pivot

Dec 14. The Bank of Japan (BOJ) is poised to remain one of the most dovish central banks globally, continuing its ultra-loose monetary policy amid uncertainties in consumption and wage growth. While internal and external factors, such as weak consumer spending and global economic risks, influence this stance, markets are keenly anticipating any indications from Governor Kazuo Ueda about exiting negative interest rates. With differing opinions within the BOJ regarding the timing of policy shifts, experts predict changes could occur as early as Apr-2023, influenced by global monetary trends and domestic economic indicators like wage increases and inflation stability. (CNA)

Philippine central bank keeps benchmark rate unchanged at 6.50% (Nikkei Asia)

Major central banks hold rates steady as markets eye rapid cuts (Reuters)

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