Stories of the Week

Renminbi markets: China cash squeeze abates but concerns remain over default risk
By Ang Chung Yuh

The worst cash crunch in China since June has eased after the central bank added CNY 29bn of capital into the interbank market via reverse repurchase contracts on December 24. The seven-day repurchase rate, a key gauge of interbank funding availability, fell 344bps to 5.4% on the same day, the steepest drop in more than two years.

The first market-wide money injection in three weeks by the People's Bank of China (PBOC) sent a strong signal of the monetary authority's determination to end the cash crunch. The injection provided had an almost immediate effect (see Figure A1) on RMI's China Equally-weighted Corporate Vulnerability Index (RMI China CVI-EW), which captures the prevalence of corporate credit risk in China.

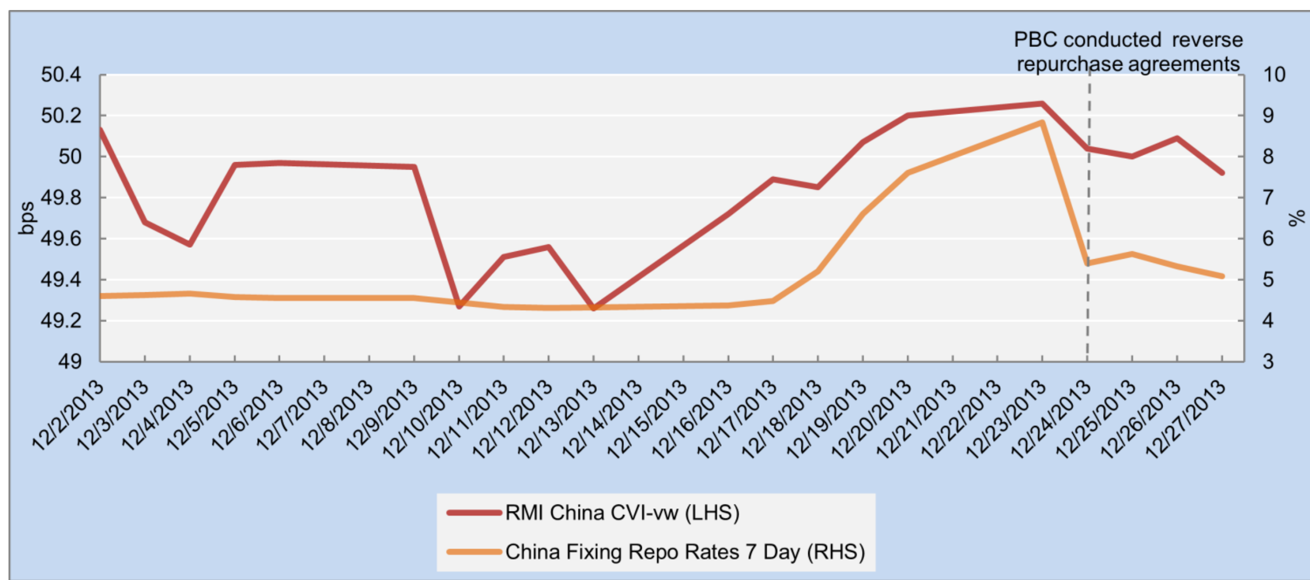

Figure A1: The RMI China CVI-EW and seven-day repurchase rate fell on December 24. *Source: RMI; Bloomberg*

However, the seven-day bond repurchase rate has averaged 5.17% this month, the highest since June, according to Bloomberg data. The benchmark money market rate stayed above 5% in the week ended December 27 even after the liquidity injection. The PBOC also refrained from further open market operations today as it tries to contain lending and inflation. The bank warned in its third quarter monetary policy report, published in early November, that the economy is set for an extended period of deleveraging.

China's second cash crunch in six months has sent the borrowing costs of Chinese firms soaring. Evergreen Holdings Group Co., an AA- rated shipbuilder, sold one-year notes at 9.9% on December 6, the highest among publicly issued onshore bonds since 1997, according to Bloomberg. Broad market Chinese bond yields surged 128bps this year to 5.36% on December 27, compared with a 44bps rise for broad market corporate bonds globally, according to index data compiled by Bank of America Merrill Lynch (see Figure A2 over page).

The central government predicted a third consecutive year of slowdown for China's economy when it estimated a 7.6% growth rate in 2013 from a year earlier, lower than 2012's expansion of 7.7%. Many analysts are concerned over the high levels of debt in the economy at a time when growth is slowing. Next year, some CNY 2.6tn in Chinese corporate debt will mature, twice the size of Ireland's economy.

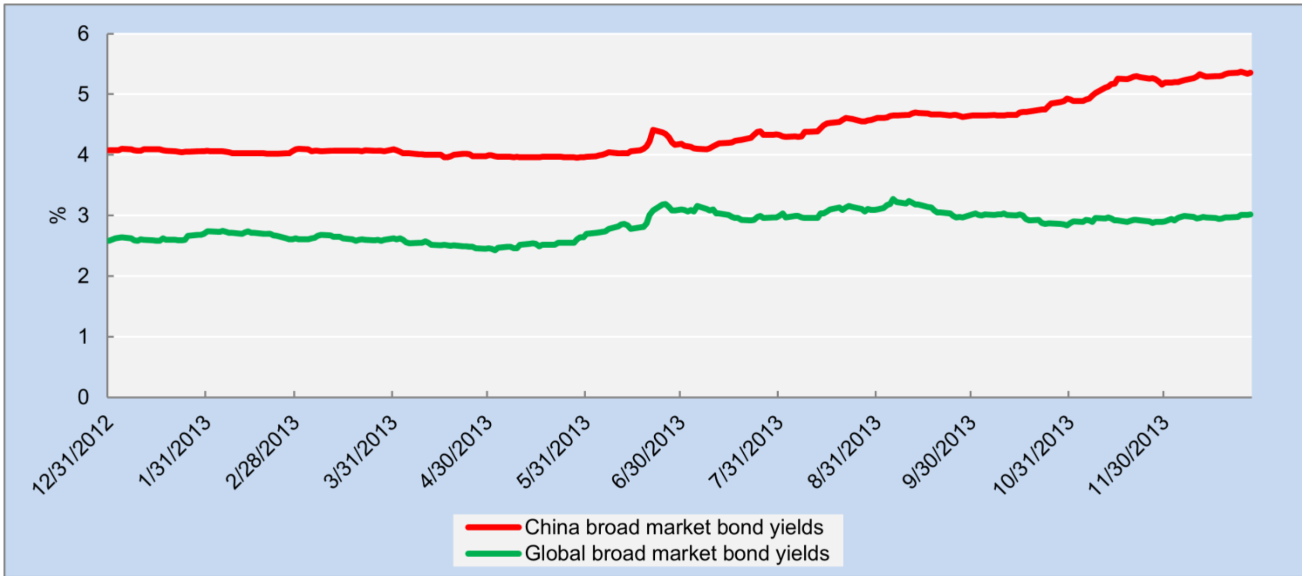

Figure A2: High borrowing costs are increasing the debt burden of Chinese issuers. *Source: BofAML; Bloomberg*

Renminbi markets: Offshore markets more insulated this time around

By James Weston

Offshore CNY markets (or CNH markets) appear largely unaffected by the sharp increase in onshore interbank rates. We have not observed the same broad sell-off of Dim Sum bonds seen during the previous onshore cash crunch in June (Figure B3, left), although the previous cash crunch occurred around the same time the US Federal Reserve suggested earlier than expected tapering of its unprecedented monetary stimulus, which could have the amplified the sell-off in Dim Sum markets. The June CNY liquidity crisis spread to offshore markets as subsidiaries of mainland banks remitted funds back onshore to help meet onshore funding needs, reducing the amount of CNY available in offshore markets and increasing offshore interbank rates. In addition, smaller Hong Kong-based banks increased deposit rates and partially liquidated some Dim Sum bond holdings.

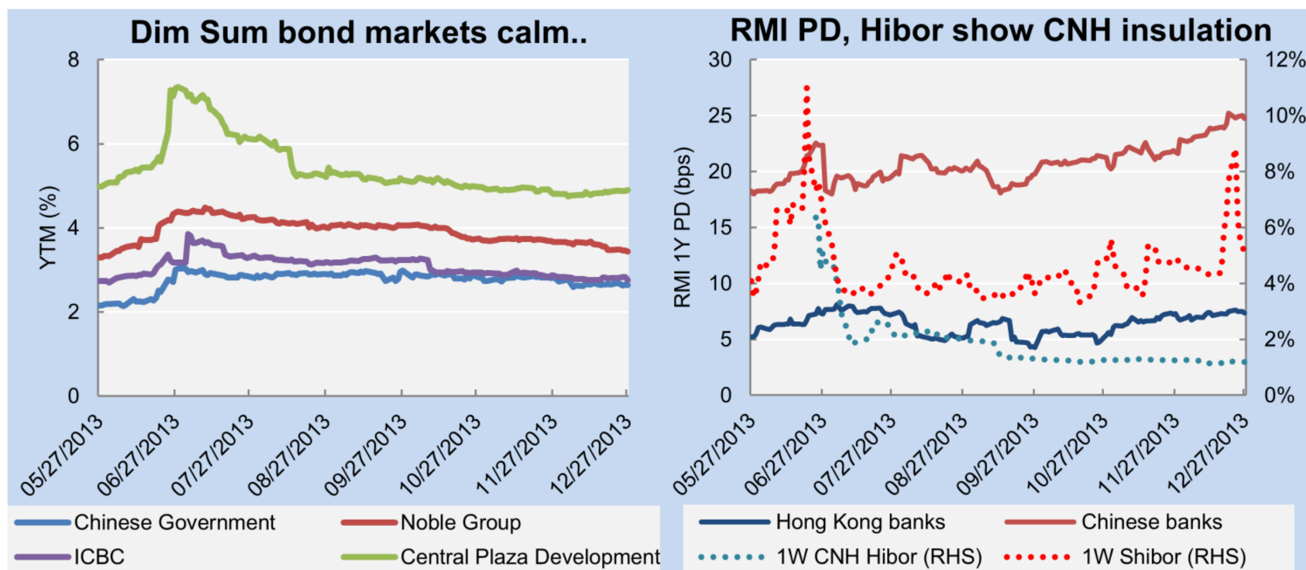

Figure B3: Yield to maturity on a number of benchmark 3-year CNY bonds issued offshore, or Dim Sum bonds (left), and aggregate RMI one-year PDs for Hong Kong and Chinese banks compared with onshore and offshore interbank rates (right). *Source: RMI; Bloomberg*

Refinements to the HKMA's CNY liquidity window introduced in July, which increased the size and immediacy of CNY available from the central bank, appears to have insulated offshore markets from last week's onshore cash squeeze. The HKMA does not publish statistics on use of the CNY liquidity facility, but the mere presence of the facility may have increased confidence in the resilience of offshore CNY markets despite problems on the mainland. We have previously mentioned the introduction of this mechanism was credit positive for Hong Kong based-banks with large CNY businesses, but no significant presence onshore. RMI CRI data reflects improved insulation of offshore markets, with the aggregate RMI 1-year PD for Hong Kong banks largely unchanged over the last month, while the aggregate RMI PD for Chinese banks peaked.

RMI PD for Turkish companies peaks as corruption scandal drives investors away
By Kim Vu

When the echo from the demonstrations against Turkish Prime Minister Tayyip Erdogan's administration in May has not faded, Ankara is again rocked by the biggest corruption scandal in modern Turkish history, and Erdogan's AK Party is right at its center. A graft scandal involving individuals close to the Turkish Prime Minister and his cabinet erupted on December 17. So far, nearly half of Erdogan's cabinet has been reshuffled following the incident.

The political turmoil plunged the Turkish Lira (TRY) to a record low during the Christmas week. The currency plunged to an all-time low of 2.15 per USD on December 27, extending its drop this year to 16% against the USD. Investors have already turned their backs on Turkish bonds after the recent announcement from the US Federal Reserve that the US central bank would trim its monthly bond purchases under its quantitative easing program by USD 10bn starting in January. The political scandal in Turkey has fueled further uncertainty among investors and resulted in selling of Turkish bonds at the fastest pace in two years. Yields on ten-year TRL-denominated Turkish sovereign bonds jumped to 9.85% on the December 26, up 40bps since December 17, extending the increase this year to 329bps.

The chart below shows that the RMI 1-year aggregate probability of default (RMI PD) for 391 Turkish listed companies and the yield to maturity (YTM) of Turkish sovereign bonds. The chart indicates that the yields on Turkish sovereign debt have largely tracked RMI's estimation of the credit risk of domestic corporates. Both measures suggest that the political scandal has increased uncertainty in the ability of the country's institutions to repay outstanding debt. Continued political instability could lead to further deterioration in the credit quality of Turkish companies.

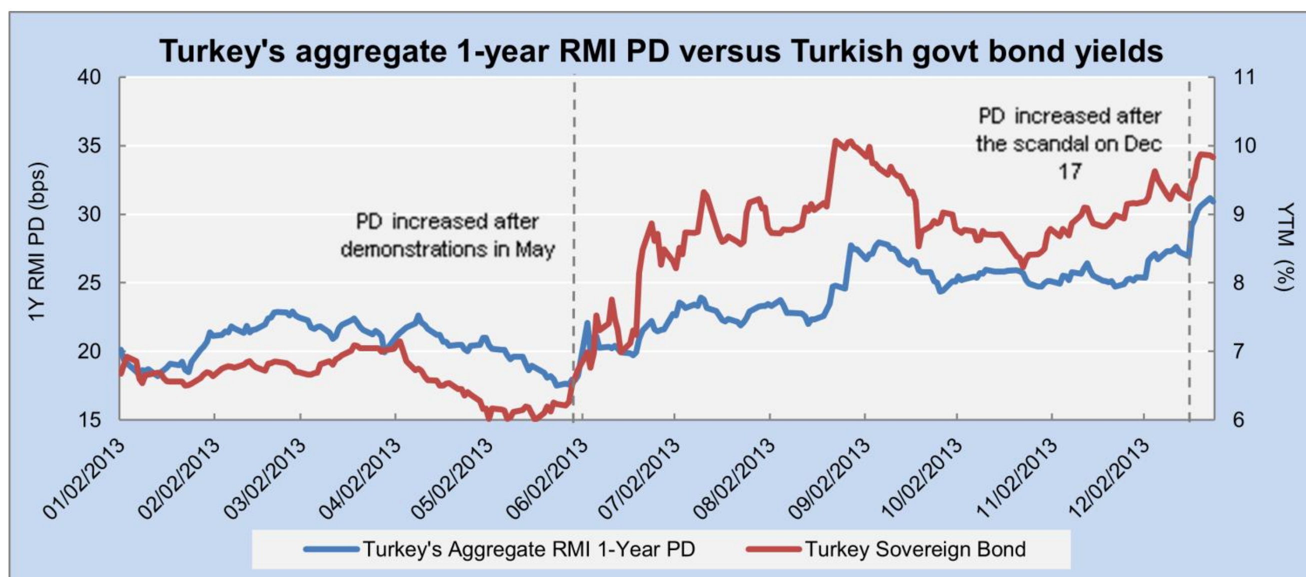

Figure B1: 1-year aggregate RMI PD for 391 Turkish companies and yield to maturity on 10-year Turkish TRY-denominated sovereign bonds. *Source: RMI; Bloomberg*

Before the crisis, the Turkish government expected the current account deficit to be USD 58.8bn (7.1% of GDP) and it forecasts a current account shortfall of USD 55.5bn (6.4% of GDP) next year. A large deficit on the current account indicates the country is borrowing savings from abroad to finance consumption, or "living beyond its means." The Turkish market now combines two investor nightmares: political uncertainty and a current account deficit.

Sources:
Foreigners Unload Turkey Bonds as Probe Tarnishes Erdogan Growth (Bloomberg)
Further gloom in store for lira as it hits record low **(**CNBC)

In the News

Rising rates favor shorter junk bonds

Dec 29. Lagging sales and lower prices of long-term speculative-grade bonds in the US are signaling that investors are favoring shorter-term securities that are less vulnerable in a rising interest rate environment. A record USD 361bn of low-rated bonds were sold this year, and the share of junk debt maturing in eight or more years represented 59% of issuance, the lowest since 2009. Moreover, borrowers are paying more to issue longer-dated debt. The difference, or spread, between junk bonds maturing in between one and ten years and longer-term high-yield bonds is up to 185bps from 7bps two years ago. (The Wall Street Journal)

Batista Oil company jumps after USD 5.8bn debt accord

Dec 27. Oleo & Gas Participacoes SA's stock price jumped after an announcement that creditors settled to convert USD 5.8bn of debt into a 90% equity stake in the Brazilian Oil Company. Oleo & Gas, formerly known as OGX Petroleo & Gas Participacoes SA, rose as much as 32% on Dec 27 and closed 16% higher at BRL 0.22. The agreement, which includes restructuring dollar bonds, may help the Rio de Janeiro-based oil explorer company emerge from bankruptcy two months after defaulting in Latin America's biggest-ever corporate debt disaster. (Bloomberg)

Japan wages pressured by fastest inflation since 2008

Dec 27. Japan's inflation in November accelerated to the fastest pace since 2008, bringing the rate closer to policy makers' target. However, it's threatening to erode household spending power unless employers increase wages. Japan is now more than halfway to the central bank's 2% inflation target, as the result of a weaker JPY and higher costs of energy. For the first time in four years, the government dropped a reference to deflation in a monthly economic report. Wages excluding bonuses and overtime remained the same in November from last year, separate data showed on Friday. (Bloomberg)

Effects of 2001 bond default still linger: Argentina credit

Dec 26. Argentina's foreign reserves are heading for the biggest annual drop since 2002, when they sank 47% in the aftermath of the country's unprecedented default on USD 95bn of bonds. Inflation that is approaching 30% sent Argentines pulling funds from the country and left reserves at a six-year low of USD 30.5bn this month, which is less than half the amount held by Peru, an economy 42% the size of Argentina. Currency controls have failed to prevent reserves from heading to a record 14th straight monthly decline, and the year-to-date decline climbed to USD 12.6bn or 29%. (Bloomberg)

Fidelity to Amundi seek Euro shelter as treasuries swoon

Dec 25. The prospects of the first successive losses on US Treasuries in at least 35 years has spooked bond investors into seeking refuge in European markets, alongside growing confidence that the ECB will be able to keep the eurozone intact. While 10-year Treasury bonds are estimated to suffer losses of 1.6% next year, yield forecasts indicate that bond returns in Spain and Italy will extend 2013's gains of as much as 11.1% into the next year. Bond investors also mentioned economic policy divergence as reasons for shifting to European markets, where the ECB continues quantitative easing even as the US prepares to taper asset purchases. However, high debt levels, severe unemployment and potential disinflation in the eurozone continue to pose lingering risks for investors. (Bloomberg)

Europe banks overexposed to domestic debt (FT)

Malaysian ringgit halts 9-week slide as stocks rise to record (Bloomberg)

Credit default swaps benchmark in US decreases for sixth day (Bloomberg)

Mizuho to restructure amid loan scandal (NY Times)

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