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Credit quality of Chinese firms remains stable despite recent defaults as economic recovery strengthens

by Raghav Mathur

- **China's bond market is facing headwinds due to a potential wave of high-profile defaults and liquidity concerns**
- **Tough stance by the government on bailing out distressed Chinese corporates is seen as a long-term credit positive as the government aims to build credibility in its credit markets**
- **Strong economic growth, coupled with reduced policy uncertainty, helps counteract the risks faced by corporates in capital markets and improves credit quality as demonstrated by NUS-CRI 1-year PD and BuDA**

In April 2021, NUS-CRI published a brief demonstrating the heightened credit risk in China's largest bad debt manager, China Huarong Asset Management (Huarong). Not only has Huarong's possible restructuring triggered a sell-off in its renminbi and dollar-denominated short-term bonds, but also highlighted offshore investors' growing concern on the health of the country's wider debt capital markets. These concerns stem from the lack of intervention by the Chinese government and the People's Bank of China (PBOC), who have taken a tough stance on government bailouts to build credibility in the world's second largest fixed-income market. However, the underlying credit health of China domiciled companies (Chinese companies) has remained relatively stable despite the initial deterioration seen at the end of last year, due to the wavering of investor's confidence in capital markets caused by high-profile defaults over the last six months. This is showcased by the NUS-CRI Aggregate (Median) 1-year Probability of Default (Agg PD) (See Figure 1a), where credit profile for Chinese companies has been buoyed by a record rebound in economic activity and reduced policy uncertainty.

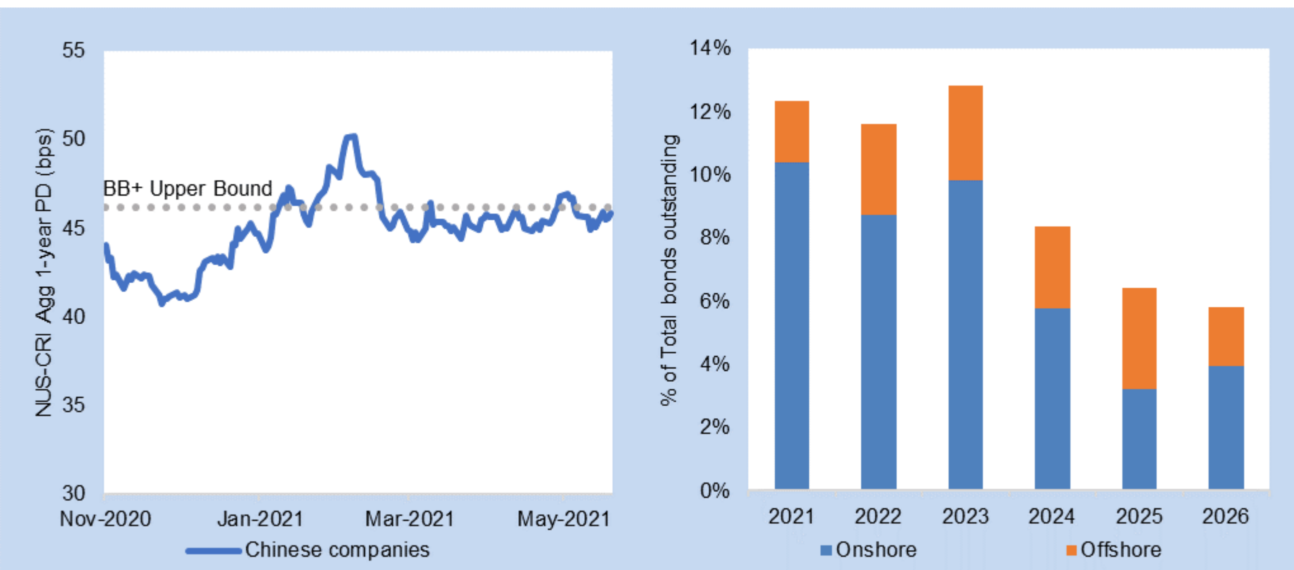

Figure 1a (LHS): NUS-CRI Aggregate 1-year PD for China domiciled firms with reference to PDiR2.0 bounds. Figure 1b (RHS): % of total bonds outstanding maturing over the next five years broken down by onshore and offshore bonds. *Source: NUS-CRI, Bloomberg*

With more than USD 1.3tn of onshore and offshore bonds maturing in 2021, and close to 40% of all bonds outstanding maturing over the next 5 years (see Figure 1b), international investors' confidence in China's debt capital markets is wavering due to a possible wave of high-profile defaults and looming liquidity issues. So far this year, USD 3.3bn of dollar-denominated principal and coupon payments have already been missed by Chinese corporates, equaling those expected in a whole year before the pandemic. The risk of default is heightened by PBOC's limited cash injections to curb companies' access to liquidity and disincentivize excessive borrowing in hopes to catalyze a long-term deleveraging trend in the market.

However, the government's recent tough stance on ‘bailouts’ may heighten investors’ fear and credit downgrades by domestic credit rating agencies (CRAs). The Chinese government aims to reduce moral hazard, particularly for troubled state-owned enterprises (SOEs) like Huarong, in order to pave the way for a mature and rational debt market. Another cause of concern for offshore investors is how companies handle the potential default process, especially if the restructuring of onshore CNY denominated debt is prioritized. This hinders access to foreign-denominated issuances for Chinese companies as investors become discouraged to invest in Chinese offshore bonds due to an increased possibility of not being paid back. Resultantly, the index yield to maturity for Bloomberg Barclays Asia ex-Japan USD Credit index for investment-grade Chinese companies has been increasing steadily from 2.24% to 2.64% since the start of the year, reaching high’s not seen since May 2020.

Interestingly, however, similar concerns are not shared by onshore investors as yields on CNY denominated bonds have been trending downwards since the middle of Feb 2021. The Bloomberg Barclays China Aggregate Index YTM has steadily dropped from 3.40% to 3.19% from Feb to May 2021 (See Figure 2a), highlighting the lower cost of refinancing for onshore bonds. This may indicate that even though China’s debt markets may face headwinds in the near future, the ‘zero-tolerance’ policy stance set forth by the government may have already been priced in as a positive for long-term credibility in the capital markets. This policy stance, though possibly painful in the short run for distressed firms, proves to be a hopeful sign of transparency and rationality for markets, rather than one which is seen as controlled and interventionist in nature. Concurrently, domestic Chinese CRAs, which have been criticized in the past for artificially high credit ratings, also seem to be moving toward a criterion that relaxes the assumption of ‘guaranteed’ government bailouts, signified by the downgrading of 366 bonds between Jan 2021 and Apr 2021, compared to 109 over a similar period last year.

Another potential key driver for improving investor confidence is the pace of economic growth and production in the country. China has been experiencing a rapid increase in economic activity in Q1 2021 with GDP growth increasing at 18.3% YoY. Simultaneously, China’s industrial production has again been a key contributor in supporting this growth, responding to a rebound in both domestic and export demand. Indicators pertaining to higher-than-expected retail sales (beating market expectations by 6.2 percentage points in Apr 2021), as well as China’s industrial Producer’s Price Index (which grew at 6.8% from a year earlier last month) demonstrate a rebound in economic activity that bodes well for both investor confidence and economic performance. Demand for local bonds may have also risen due to the perception of stable monetary and fiscal policy moving forward. China’s Policy Uncertainty index (PUI), which aims to capture uncertainty in local government institutions’ policy announcements, has dropped from 723.9 in Nov 2020 to 482.0 in May 2021.

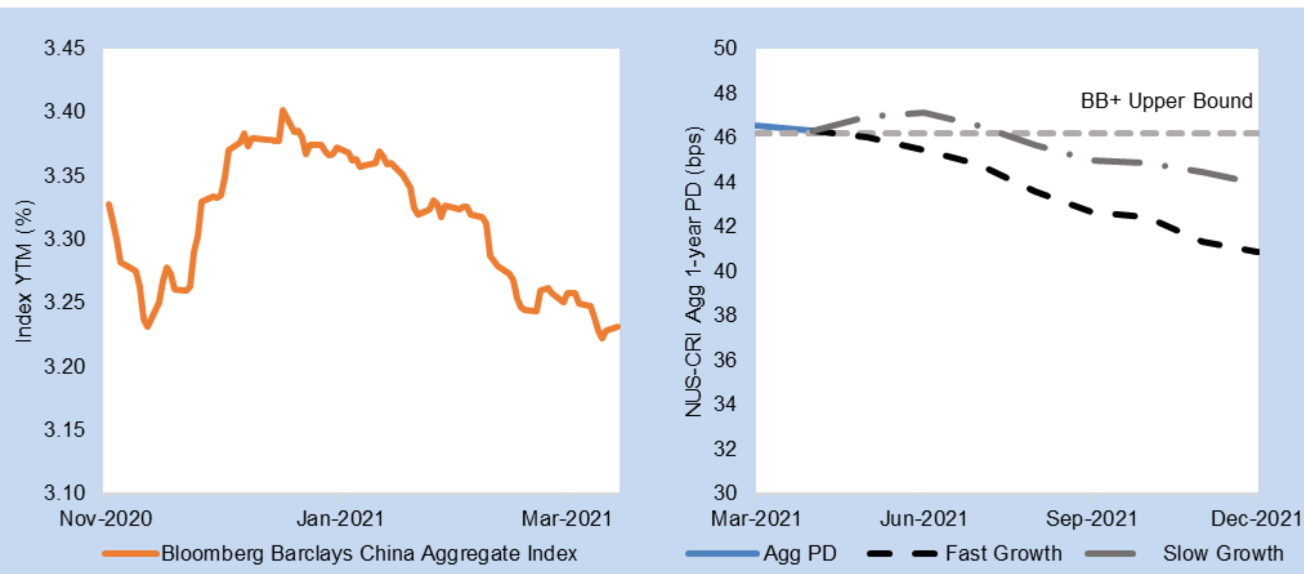

Figure 2a (LHS): Index Yield to Maturity of Bloomberg Barclays China Aggregate Index from Jan 2021 to May 2021. Figure 2b (RHS): Agg PD and Stressed PDs of Chinese companies dependent on multiple improving economic environment and lower index YTM using BuDA. *Source: Bloomberg, NUS-CRI*

As such, we utilize the NUS-CRI Bottom-Up Default Analysis toolkit (BuDA[1]) to stress test GDP Growth rate and the Bloomberg Barclays China Aggregate Index YTM[2] against the NUS-CRI Agg PD for China to capture the impact of the improving macroeconomic environment on the credit health of Chinese companies over the next 6 months for two scenarios. Our first scenario (Fast Growth) assumes GDP growth of 5% QoQ, and a decrease in the index's YTM of 1% per month. The second scenario (Slow Growth) assumes a more conservative GDP growth of 3% QoQ and the decrease in the yield of only 0.5% per month. The result of the stress test is demonstrated in Figure 2b above. The BuDA results indicate that the Agg PD falls from 47bps to 40bps in the first scenario and 43bps in the second scenario over the next 6 months, highlighting the impact of the positive economic performance on the aggregate credit quality of Chinese companies.

Though China's credit health has benefitted from a rebound in economic activity since the start of the year, the Agg PD is still considered non-investment-grade level when referenced to PDiR2.0 bounds under the scenarios shown in the BuDA results. Furthermore, economists believe that the pace of economic growth is bound to slow down in the long term. These sentiments are primarily driven by structural reasons like the country's transition towards a more service-driven economy that has slower productivity growth and a shrinking labor force. On the other hand, Chinese companies seem to be paying further attention to ESG concerns as green bond issuance has rebounded this year. With more than USD 17.7bn of green bonds sold in Q1 2021, the highest amount issued since Q3 2019, the country, as a whole, is making progress towards reaching its net-zero greenhouse gas emission goal by 2060 through regulatory reform. However, eyebrows have been raised about the country's domestic ESG standards not being aligned with international standards, raising fears of greenwashing and arbitrary use of funds. If regulatory watchdogs can close this gap in the future, Chinese companies may have greater accessibility to offshore investors and build further credibility in their capital markets.

[1] The Bottom-up Default Analysis (BuDA v3.3.0) is a credit stress testing and scenario analysis toolkit jointly developed by the Credit Research Initiative (CRI) team of National University of Singapore (NUS) and the International Monetary Fund (IMF)

[2] We stress test against the Index YTM not only to judge the impact of the lower refinancing cost for Chinese companies, but also to capture sentiments pertaining to lower policy uncertainty.

Credit News

China Braces for USD 1.3tn Maturity Wall as Defaults Surge

May 24. China faces USD 1.3tn worth of domestic debt repayments over the next 12 months arising from its liberal credit binge. Investors are left uncertain, as Chinese borrowers have defaulted a significant amount on local bonds, partially due to moral hazard lapses. Chinese policymakers now have to juggle between purging the debt market by allowing delinquent companies to default while still ensuring a healthy credit market. Investors are now reducing the tenor on bonds purchased from 3.22 years across 2020 to 3.02 in 2021 as they try to limit exposure to an increasingly risky asset class. The country suffers from a lack of long-term institutional investments in the bond market, making longer-term bonds harder to sell. As a result of such structural issues, China regularly faces refinancing risks, which are likely to be made worse with the recent spate of high-profile defaults. (Bloomberg)

Rising bond yields test ECB nerves ahead of decision on tapering

May 22. There has been a rise in borrowing costs for EU governments, which has put policymakers on edge as they consider pulling back their bond-buying program. Some ECB council members are pushing for a rollback in dovish economic measures, partially attributed to a rise in Germany's 10-year yield to -0.12% in May 2021, indicating investor sentiment on rising inflation. However, policymakers are focused on ensuring healthy financing conditions for the relevant parties in the EU to facilitate economic recovery. There is still a possibility that the ECB may slow down purchases, and the eventual rise in borrowing costs may affect financially weaker economies in the region. (FT)

Lenders struggle to recoup losses after US corporate debt defaults

May 18. Investors have suffered from weak underwriting standards and shifts in corporate debt standards during the pandemic. These issues have led to a lower recovery rate of 45 cents on the dollar for bonds they owned, which was lower than the 59 cents during the Global Financial Crisis. These changes in corporate debt standards allowed companies to avoid filing for bankruptcy during the pandemic. However, companies that did file for bankruptcy were in a worse financial state than they would have been before these changes in standards. In addition, investors are investing more in higher priority debt, which has diluted the overall claims for all stakeholders in cases of default. (FT)

China's capital inflows hit 7-year high on bond-buying bonanza

May 21. Net capital inflows into China have risen to a seven-year record high of USD 88.5bn across Jan 2021 to Mar 2021, as investors look to benefit from the country's higher interest rates. The divergence in interest rates between China and other advanced economies widened as the country rebounded quickly from the pandemic. The balance of CNY denominated bonds held by offshore investors increased by almost 60% from 2020 to CNY 3.55tn in Mar 2021. Chinese corporates have benefitted from the increased demand for materials, as global supply chains in other emerging markets were disrupted by the pandemic. This, alongside strong CNY appreciation not seen since Jun 2018, has helped drive the demand for Chinese bonds in recent months. (Nikkei Asia)

Issuance of Bundles of Risky Loans Jumps to 16-Year High

May 18. Investors are worried that rising inflation and future interest rate hikes may erode corporate bond returns going forward. As such, yields from bonds tied to Collateralized Loan Obligations have become more attractive. Issuances of CLOs rose to a record USD 59bn in May 2021, the highest amount for that period since 2005. The economic rebound from the depths of the pandemic has improved the outlook of junk-rated issuers, with the number of nonfinancial junk-rated issuer defaults having fallen to its lowest since 2018. However, other investors have had their doubts. Average yields of AAA-rated CLOs provided a spread of 1.16% above LIBOR, lower than the 1.31% spread provided in Dec 2020. Furthermore, liquidity in the CLO market has faced uncertainty, with certain CLO tranches being unable to trade consistently. (WSJ)

Canadian bank earnings set to beat rising estimates on deal fees, reserve releases (Reuters)

Norwegian Air raises fresh capital, set to exit restructuring (Reuters)

China's USD 2.14tn of bonds coming due unnerves foreign investors (Nikkei Asia)

Regulatory Updates

Fed's Harker says important to talk about tapering sooner rather than later

May 22. Federal reserve official Harker claimed that Fed should consider reducing asset purchases sooner than later and should communicate the plans in advance. Should the recovery continue to be strong, officials would consider raising interest rates and changing monetary policy. However, this view has been shattered by the labor market data showing sluggish growth. Harker said that he is looking for continued strength in the labor market before the Fed removing the accommodation. He estimated that the U.S. economy may need to add up to 11mn jobs to cover the gap left by the pandemic. Before it's "appropriate" to talk about tapering, he said he wants to see inflation rise above the 2% target and average 2% over time. (Reuters)

FCA warns UK fintechs against comparing themselves to banks

May 19. Many fintech companies compare themselves to banks and fail to warn consumers about the risks of using their services. The FCA on Tuesday requested over 300 companies to remind their customers of the risks of keeping money in accounts not covered by the Financial Services Compensation Scheme. It warned that some companies were "misleading" customers about how heavily their products are regulated. The FCA sent a letter to the chief executives of companies with E-money licenses, highlighting regulators' growing anxiety about the size and influence of lightly regulated payments companies. The fallout of Wirecard in June last year underlined risks for E-money customers after millions of accounts were frozen for days. (FT)

Mexico to get new central bank chief with 'social dimension' (Reuters)

Bank of England aims for greener corporate bond portfolio (Reuters)

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