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CHINA'S CORPORATE DEBT: TRIAGING IN PROGRESS

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With ~18% of global outstanding debt currently yielding in negative territory, investors are increasingly looking for yield-enhancing opportunities in higher risk Emerging Market assets. In this context, China has emerged as a big capital hook, given its resilient economy, stable currency and relatively liquid fixed income market. Despite the recent increase in global long-term rates, the portion of negative-yielding debt remains non-negligible, making it increasingly difficult for investors to get decent yields (Figure 1). To put things into perspective, there are currently ~USD12trn negative-yielding bonds in a USD67trn market, according to broad fixed income aggregates; this means that ~18% of global outstanding debt is currently yielding in negative territory.

Figure 1: Global negative-yielding debt market value (in USD trn)

Sources: Bloomberg Barclays Index, Allianz Research

In this context, and despite the initial outflows in March 2020, investors have continuously been shipping capital overseas, targeting Emerging Market (EM) assets, which due to their higher risk profile and ex-core currency denomination offer an interesting yield-enhancing opportunity. At this point in time, inflows into EMs continue at a relatively steady pace and are stabilizing (Figure 2).

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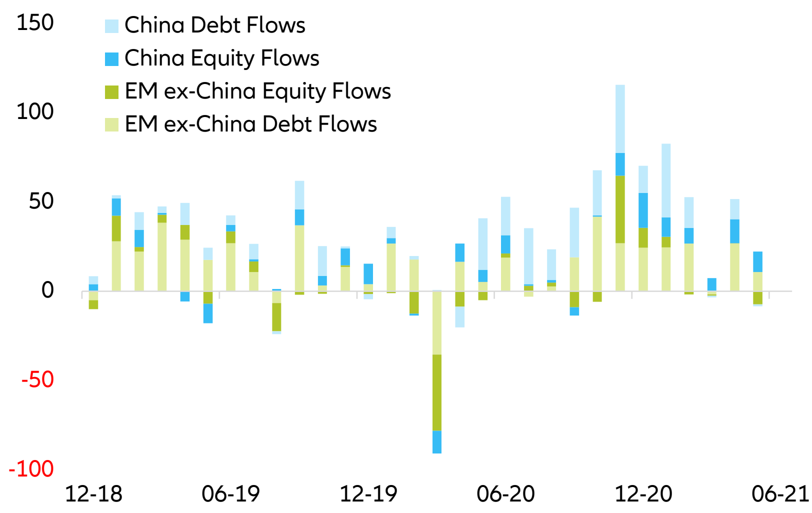
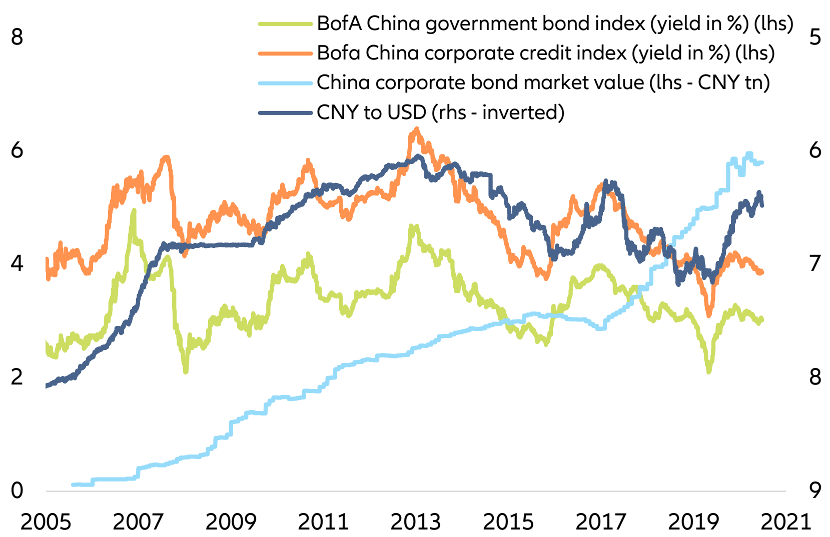
Figure 2: Total portfolio flows into Emerging Markets (in USD bn)



Sources: National Sources, Bloomberg, IIF, Allianz Research

Across different segments within the Chinese fixed income market, the CNY government bond market has attracted more and more investor attention, given its stable but attractive rates and currency components, and has been included in various global indices. But the onshore CNY credit market, which has still low foreign participation, has so far only attracted investor curiosity rather than real money. The onshore CNY credit market has a quasi government-like behavior due to a non-negligible amount of state-owned enterprises (SOEs), and typically acts as a restrainer for downside / default risk potential while still offering a 80 to 100bps pick up vis-a-vis its sovereign counterparts (Figure 3).

Figure 3: China onshore sovereign vs corporate markets

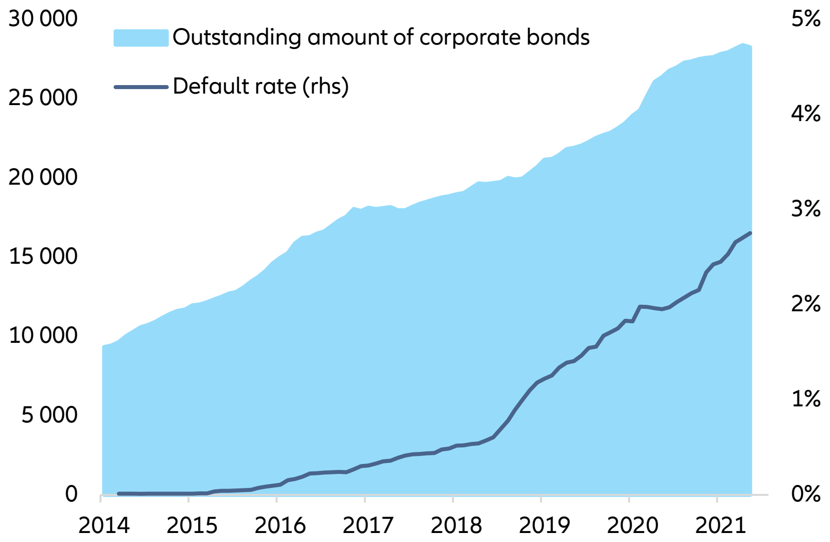


Sources: BofA, Refinitiv, Allianz Research

In addition to the getting-popular onshore CNY government bond market and the less developed onshore CNY credit market (Figure 4), China also offers a well-represented and benchmark-aware investible dollar credit universe through JPM JACI (J.P. Morgan Asia Credit Index Core) or CEMBI (J.P. Morgan CEMBI Broad Diversified Core Index), which better satisfies the need of global institutional investors. China USD credit currently has a BBB+ rating and offers a c.a. 290bps spread over US treasury, which is well supported by the country's economy and is a sweet spot when compared to other regional credit peers as both the rating quality (vs EM peers) and the spread compensation (vs DM peers) are substantially higher.

However, recent high-profile defaults have shaken investors' faith in the state's implicit put protection. Take for example the case of China Huarong Asset Management Company, a central SOE, which announced that it could not meet the scheduled deadline for the fiscal year 2020. Following the release failure, a debt sell-off was triggered, sending bond prices down to ~60 cents on the dollar. This led several well-established Chinese Investment Grade companies, including Tencent, to pause new debt issuance while some other SOE and financial bonds also traded at a wider range. The overall CEMBI China spread widened notably by ~65bps in the first two weeks of April.

Figure 4: Outstanding amount of onshore corporate bonds & default rate

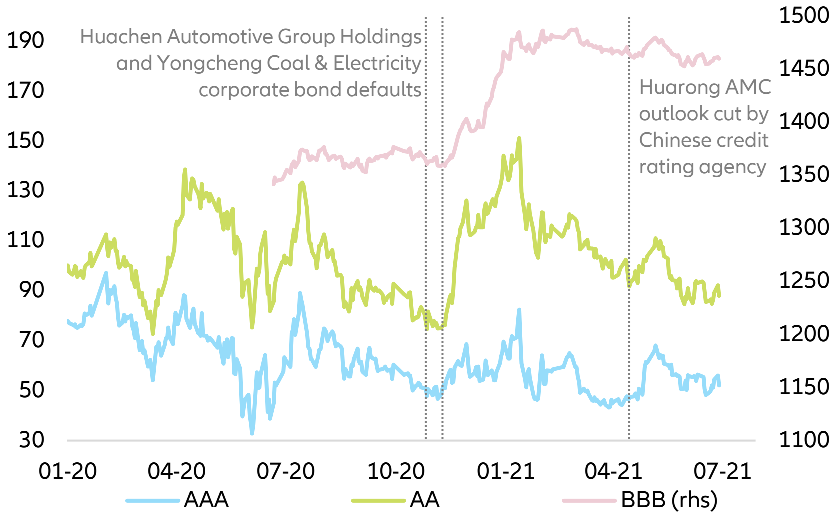


Sources: Wind, PBOC, Allianz Research

Why is the Huarong case particularly worrying for investors? Huarong is China's biggest (RMB1.7trn) and one of the only four state-appointed distressed debt managers, which results in a close linkage to plenty of onshore financial institutions. Huarong and its subsidiaries together have USD23bn in foreign currency debt and USD19bn in local currency debt. Due to its relatively large debt volume, lots of local and foreign investors are directly or indirectly invested in the company. Huarong is also deemed to be systemic in China's financial system given its operational nature and history.

Its default followed two local SOE defaults in late 2020, which already started shaking investors' faith in China's SOEs. These two SOEs were Huachen Automotive Group Holdings, which defaulted in October 2020, despite having a top-notch rating, and Yongcheng Coal & Eletricity, a SOE in the Henan province that defaulted one month later. The consequent market reaction to these events (Figure 5) reflected **investors' concerns that SOEs might be purposely skipping their debt payments, a traditional case of unwillingness to pay, rather than inability to pay.**

Figure 5: Corporate bond 1-year spread vs. government yield (bp) (Onshore CNY)

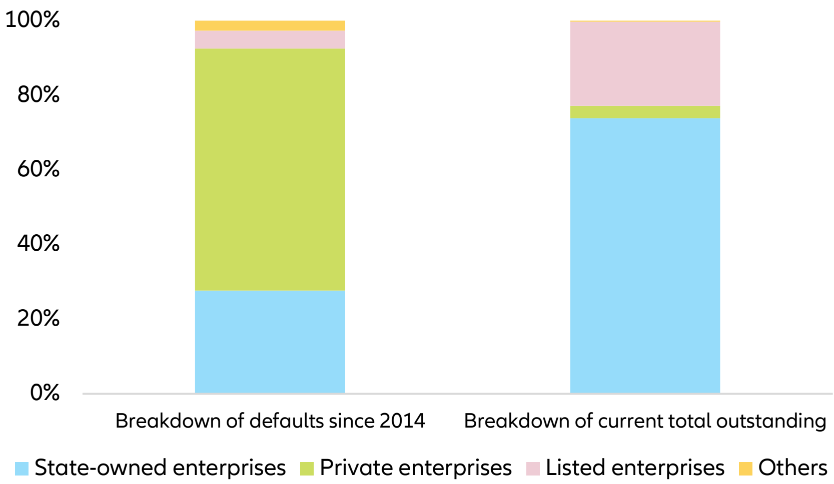


Sources: Wind, Allianz Research

More importantly, these cases hinted at a climate more accepting of corporate failures. As a result, bondholders have become increasingly concerned and more risk averse towards Chinese credit, both onshore and offshore. As Chinese authorities did not immediately communicate on the events or their implications, market participants began to structurally doubt the strength and resilience of the previously undoubted downside protection coming from Chinese authorities to SOEs. In the past, Chinese local governments have usually intervened to prevent defaults, bailing out weak issuers to avoid layoffs and ensure market stability, which in turn allowed SOE total debt to balloon to more than 65% of GDP. In the onshore corporate bond universe more specifically, the outstanding amount for SOEs represents around 75% of the total. This compares with just 3% for private enterprises and 23% for listed companies. The offshore credit market has c.a. 25% SOE hard currency issuance, much lower percentage but still considerably high in absolute volume (Figure 6).

All in all, the number of defaulted SOE bonds and the default rate (less than 3%), though it is increasing, remain close to negligible as the universe is sufficiently large. However, the signal to investors is worrying as SOEs, both central and local, together compose most of the Chinese credit market in both local and hard currencies.

Figure 6: Breakdown of corporate bonds by company ownership, defaulted and total outstanding (Onshore CNY)



Sources: Wind, Allianz Research

The rising defaults aren't necessarily a bad thing. We would argue that such defaults are a healthy and necessary step for the Chinese credit market to consolidate and stabilize, leaving some necessary room for Chinese authorities to further clean up bad debt and move towards a more market-oriented manner. Consequently, we expect some exacerbated volatility in the short run but we also expect investors to be able to benefit from a healthier and more efficient environment in the mid to long run.

However, it is important to bear in mind that despite the good intentions of the Chinese government, there is a non-negligible probability that things do not go as expected. In this context, if government support turns out to be weak, it will trigger large waves of SOE bond downgrades, leading to a systematic crisis in the Chinese financial system. In our view, though, this remains a tail event. In the isolated Huarong case, the tool box is sufficient, including measures such as implicitly guiding banks to provide liquidity to Huarong or expanding further tools such as financing support in the form of a Credit Risk Mitigation Warrant (CRMW).

Recently, Chinese authorities have finally shed some light on how they intend to deal with Huarong, indicating that they want to secure the company's strategic role so it can continue its core business of distressed asset management, and reform it by selling non-core assets and business lines, a sign of the determination to further clean up the country's bad debt and to guarantee financial stability. From a broader target perspective, maintaining financial stability has been and remains the utmost priority for the Chinese government, which certainly has a strong wish and the necessary tools (eg. high level of FX reserves and manageable level of public debt, mostly domestically-owned) to prevent any increase in systemic risk. This is even reinforced by the fact that in the past few years, financial watchdogs have gained experience in dealing with different types of credit failures, including taking over financial institutions such as Baoshang Bank.

In this regard, we believe that Chinese top authorities could seize the opportunity of the Huarong failure to come up with a plan to deal with similar future challenges. This is of particular interest since on the one hand, Chinese authorities regard breaking the implicit guarantee and implicitly forcing SOEs to responsibly operate their businesses as critical for the long-term healthy development of credit markets. On the other hand, they do need to manage investor fears so that negative market sentiment itself does not lead to any structural financial market instability. As a result, to find and maintain the balance between debt cleanup and market stability will be a challenge for Chinese authorities to overcome and for investors to monitor. But we remain positive that they will manage, as indicated by the latest developments.

What does this mean for investors? Firstly, we believe that with a mid- to long-term investment horizon, the risk-return reward of Chinese credit remains highly attractive. This is particularly the case, as previously said, since the Chinese fixed income market is a trillion-dollar-plus market that has an average BBB rating, with more than ~3% yield compensation in both local and hard currency terms. This when compared to other relevant EM markets remains highly attractive, especially given the current low-yield environment.

Secondly, the favorable macroeconomic environment, the large and steady local investor base, a rather stable FX rate and a determined government body certainly speak to the intrinsic value behind the economic attractiveness of China.

The quick rebound from the Covid-19 crisis is testament to this strength: the Chinese economy was already operating at c.75% of usual levels one month after containment measures were put in place in January 2020[1], and this earlier recovery has allowed it to win export market share since the beginning of the crisis[2] (23% on average in 2020-21 vs. 19% on average over 2017-19). This quick economic rebound (GDP grew by +2.3% in 2020 while it contracted in most other major economies) allowed Chinese authorities to start tightening the policy mix as soon as Q4 2020, ahead of the global trend. All this ensured a strong performance of the CNY in 2020, with 6.5% appreciation against the USD and 3.7% appreciation against a basket of currencies (CFETS RMB Index) over the year.

Going forward, even though China's recovery still needs to broaden[3] – notably regarding household consumption – we expect the economy to post solid rates of growth in 2021 (+8.2%) and 2022 (+5.4%). This means that on the policy side, authorities can continue to focus on managing long-term vulnerabilities (eg. in the real estate and financial markets) instead of only short-term economic support. We expect the USDCNY rate at 6.3 at year-end (vs. 6.5 at 2020-end).

Thirdly, China has an ambitious long-term plan for structural reforms in order to ensure a smooth transition to lower potential growth as the economy matures[4]. Part of the "dual circulation" strategy that was first introduced in May 2020 is capital account liberalization and renminbi

[1] See "Covid-19: After a lost quarter, 75% of the Chinese economy is back" for further details.
[2] See "Winning exports market share despite the Covid-19 crisis" for further details.
[3] See "Grand reopening: new opportunities, old risks" for further details.
[4] See "Dual circulation: China's way of reshoring?" for further details.

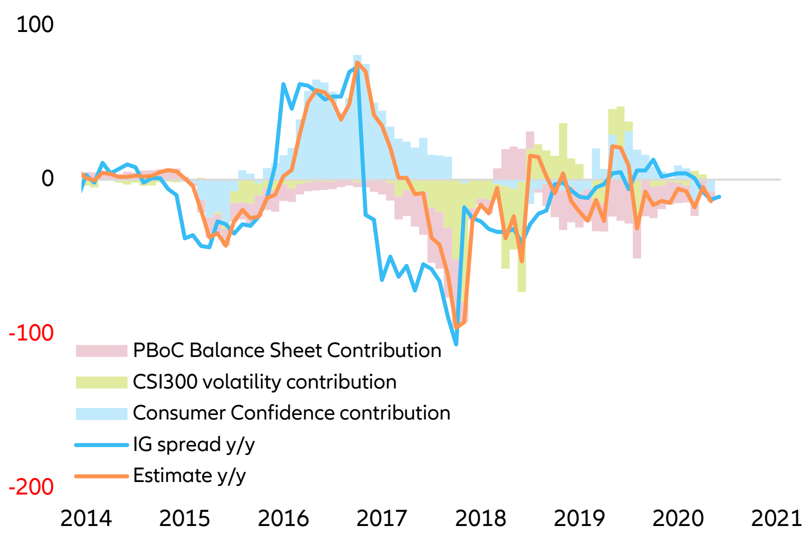
internationalization. To that end, efforts for Chinese equities and bonds to be more market-driven and reforms to ease foreign investors' access to China's capital markets will continue. Allowing unperforming SOEs to default removes the perception of implicit guarantees from the government that allows for moral hazard. The latest acceleration of credit downgrades (~375 rating downgrades until April 2021 compared to and average ~100 rating downgrades per year during the previous three years) will slowly bring more transparency to the market and gradually but steadily allow a re-pricing of "real" credit risk without spooking investors.

Last but not least, China has a firm commitment to accelerate the development of a green and low-carbon circular economic development system. In Febuary 2021, the State Council, China's cabinet, released guidelines that target peak carbon dioxide emissions by 2030 and achieving carbon neutrality by 2060. Such commitment is also a step in the right direction that matters to all investors.

From a carry perspective, it all sounds good. But is the Chinese credit market expensive? Trying to disentangle the drivers behind credit spread moves within the Chinese credit market is more difficult than in other markets. This is especially the case as credit spreads currently contain an implied put protection due to their SOE concentration, making it difficult to disentangle the pure monetary policy effect from their intrinsic governmental put protection. This is the case even considering the latest SOE defaults.

Nonetheless, our proprietary model shows that the combination of slowly disappearing monetary and policy support, combined with depressed equity market volatility and somehow stable but increasing consumer confidence, have managed to keep investment grade credit spreads stable at 80 to 90 bps, which from a historical perspective is extremely tight. However, even if from a historical perspective spreads remain extremely narrow, we do not have many reasons to believe that this situation is prone to a quick change in 2021 (Figure 7).

Figure 7: China IG spreads decomposition (y/y change - bps)

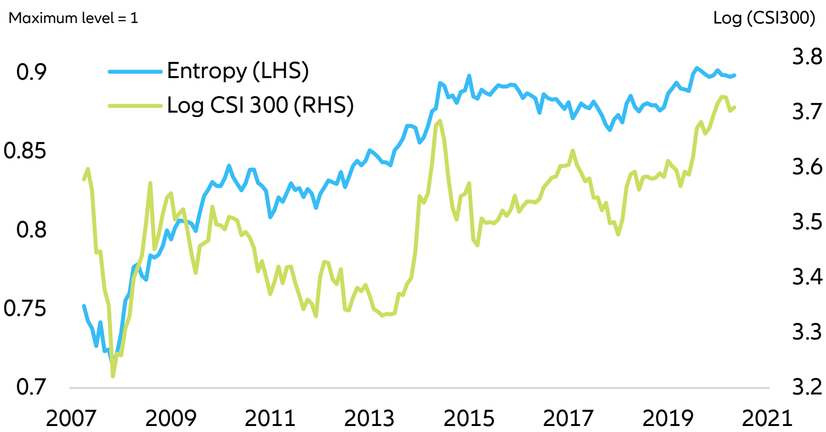


Sources: BofA, Refinitiv, Allianz Research; IG: Investment Grade

Despite having reached this equilibrium, and due to the restructuring/ consolidation of the Chinese credit market currently in the pipeline, we believe Chinese credit spreads could be prone to a timid but structural widening on the back of the progressive detachment of government support. From a tactical perspective, it is worth considering that the forecasted increase in market volatility due to discrete defaults paired with some market hiccups due to rating downgrades may offer tactical investors interesting entry points.

Interestingly, and because of the well-proven structural interlinkage between equity volatility and corporate credit spreads, it is worth noticing that the concentration risk (sector concentration risk) as measured by our proprietary equity entropy index signals that Chinese capital markets are well diversified and offer a greater backstop versus adverse outcomes than the US or the Eurozone, making the Chinese market a more balanced and compensated universe (Figure 8).

Figure 8: CSI300 entropy indicator



Sources: Refinitiv, Allianz Research; The higher the entropy the more diversified the index

These assessments are, as always, subject to the disclaimer provided below.

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