



# INCOME PARTNERS

NOVEMBER 2020

## VIEW ON CHINA ONSHORE CREDIT REPRICING

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### WHAT HAPPENED?

After the unexpected default of a locally AAA-rated provincial level State Owned Enterprise (SOE) Yoncheng Coal, China onshore investors became concerned about the underlying credit quality of the onshore corporate bond issues. Such development has triggered a repricing of onshore credit market, in particular among the weaker local government owned SOEs and LGFVs.

### OUR TAKE

#### 1. China is moving toward a more efficient and market-driven credit market

Since 2015, China's onshore credit market has become more and more market driven, with default rate gradually rising from zero to 1.83% YTD. During 2015-2017, defaults mainly happened in small and weak private-owned-enterprises. Going into 2018, under the government deleveraging policy, funding environment became further tightened in the private sector which resulted in steady increase in onshore default rate to 0.86% in 2018, and higher still in the following years. Prior to 2019, most onshore defaults took place in the private sector. However, since last year, with the default of some SOEs such as HNA Group, Peking University Founder, and more recently the unexpected default of Yoncheng Coal, onshore defaults have also extended to issuers with SOE background.

At Income Partners, we have been vigilant to the onshore default risks since the very beginning. Our onshore investments have been focused on high quality government bonds, policy bank bonds and quasi-sovereigns which are investment grade rated with minimal default risk.

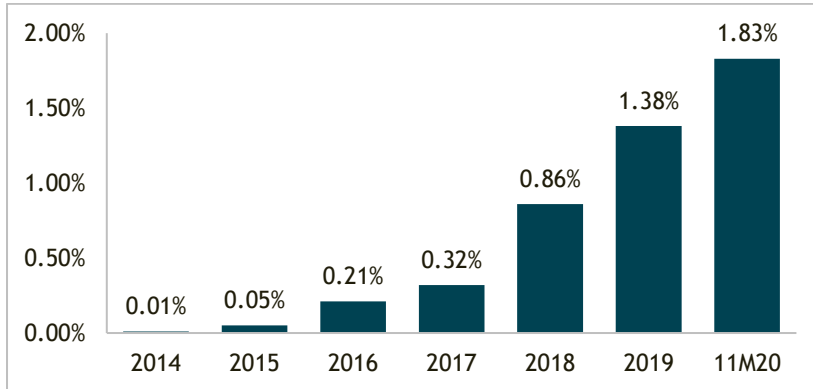
#### 2. No systemic risk but a repricing of onshore credit market, mainly in the High Yield sector

The onshore credit spread differential between investment grade and high yield has been tight relative to that in offshore market, as the default rate in China onshore bond market only started to pick up and became more market driven since 2015. After the default of Yoncheng Coal last week, the onshore credit spread level has been on a widening trend, particularly in the high yield sector, as investors started to consider credit risks in earnest. We deem such repricing and credit differentiation of onshore credit market positive as it is a healthy development toward a more transparent and efficient credit market.

In addition, we do not consider the recent defaults pose systemic risk due to (1) China's YTD onshore default rate is still low at 1.83% even under the impact of recent pandemic, which shows the resilience of China's economy; (2) With much lower Debt/GDP ratio than Developed Markets, Chinese government and central bank have the resources and power to contain systemic risks, if any; (3) Only selective local SOEs and LGFVs are with weak fundamentals. There are many more strong credits in sectors such as utility, consumer, manufacturing, etc.



### China's Onshore Default Rate



Source: WIND, JP Morgan, as of 13 November 2020

### China's Onshore Credit Spread

Onshore Local Credit Rating	Generally Implied International Credit Rating (Moody's/S&P/Fitch)	3y CGB Credit Spread (bps, as of 17 Nov 2020)	Weekly change of CGB Credit Spread
AAA	A to BB	89	+11
AA+	BB to B	130	+18

Source: Wind, Income Partners

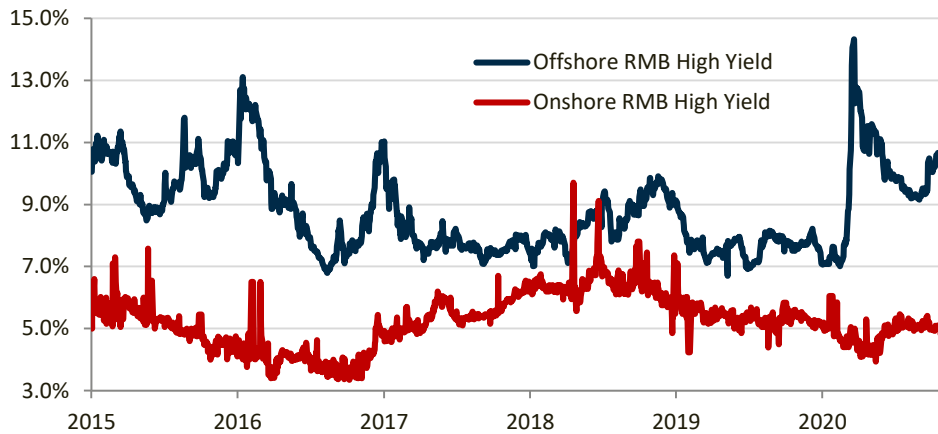
Representative index: Wind Unsecured AAA rated 3-year Bond Index and AA+ rated 3-year Bond Index

### 3. Limited impact on the offshore USD Chinese High Yield bonds as they offer much higher risk premium already

Due to different investor base and market mechanism, offshore USD-denominated Chinese high yield credits have been trading at a wide premium over onshore CNY-denominated credits, for the same name, tenor and risk. Furthermore, all issuing documents in the offshore market meet international standard, with typical high yield covenants such as cross-default terms, to protect investors. This is why we see better relative value in the offshore market for Chinese high yield credits. Considering the wide spread between onshore and offshore Chinese credits, we believe that, even if the repricing of onshore credit market continues, the potential impact on offshore Chinese high yield will be limited and manageable. At Income Partners, we have always considered underlying credit quality as the most important factor in our credit analysis, and adhere to prudent credit selection as well as portfolio diversification for the best control of default risk.



#### Relative Value Seen in Offshore Chinese High Yield (YTM in RMB)



Source: Bloomberg, Wind, 16 November 2020

Representative index: Onshore RMB High Yield - Wind Unsecured AA rated 3-year Bond Index, Offshore RMB High Yield - Bloomberg Barclays Asia USD High Yield Bond Index hedged into RMB

#### 4. Good investment opportunities in onshore investment grade bonds if the repricing continues

For Chinese credits, typically only central SOEs or strong private companies (such as Tencent) can be rated investment grade by international rating agencies, as corporate ratings are capped by China's sovereign rating A+. Unlike high yield, Chinese investment grade have been trading closely between onshore and offshore markets. This explains why we see more relative value in investment grade over high yield for onshore credit investment, as most of the investment grade names are strong quasi-sovereign names with minimal default risk. In the event where repricing of onshore credit market continues and even spreads to these high quality investment grade names, we would capitalize on the opportunities offered by IG names trading at wider levels.

#### 5. Opportunity to extend duration in onshore rates bonds to position for potential flight-to-quality rally

Based on past experience, domestic mutual funds might be forced to sell liquid rates bonds to meet redemption requirements where there was a credit crunch. However, once dust settled, flight-to-quality ensued and investors replaced credit bonds with rates bonds for safety. This was clearly illustrated in 2018 during China deleveraging policy.

At the time of writing, some selling pressure in rates bonds has emerged which may last another 2 to 3 weeks. We are monitoring the situation closely for opportunities to gradually extend duration in rates bonds in order to capture the potential flight-to-quality rally.



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