INCOME PARTNERS

DECEMBER 2020

CHINA ONSHORE BOND MARKET QUARTERLY

A lot of interesting development has been taking place in China's onshore bond market since our September inaugural issue of China Onshore Bond Market Quarterly. On the onshore credit front, while the recent State Owned Enterprise (SOE) defaults has triggered a mild repricing of the credit market (mainly in High Yield credit), we deem it as a necessary and healthy development toward a more transparent and efficient credit market, and do not consider the recent defaults pose systemic risk. As for the RMB currency, as we expected, the currency has performed strongly amid the weak dollar environment and our constructive stance on the currency remains for the medium term. Finally, regarding onshore rates, in the near term we stay somewhat defensive. However, in the medium term, we believe we are getting closer to a turning point for potential rates rally opportunity.

UNEXPECTED YET CONSTRUCTIVE DEVELOPMENT IN THE ONSHORE CREDIT MARKET

Recent onshore SOE credit events took the market by surprise

In October and November, a series of both expected and unexpected credit events erupted onshore. The most striking aspect of these events is that this wave of defaults concern mostly the SOE space- a segment of the credit market where investors generally had more confidence in. The table below chronicles those credit events:

Date	Issuer	Ownership status	Event
23-Oct-20	Huachen Automotive Group	Local SOE	Defaulted on privately placed bond
23-Oct-20	Shenyang City Public Group	Local SOE / LGFV	Filed bankruptcy and defaulted on privately placed bond
30-Oct-20	Tsinghua Unigroup	Central SOE	Failed to call back perp
5-Nov-20	Qinghai Provincial State-owned Assets Investment Management	Local SOE	Failed to call back perp
10-Nov-20	Yongcheng Coal & Electricity Holding Group	Local SOE	Defaulted on short term paper
13-Nov-20	Baoshang Bank	Local SOE (bank)	Fully wrote off Tier-2 capital bonds

Following high profile SOE defaults such as Huachen/Tsinghua Unigroup, the Yongcheng Coal & Electricity Holding Group case was indeed the last straw. The company's surprise default on its RMB1bn of short-term commercial paper on 10 Nov 2020 triggered the sharp credit market sell off. Just three weeks before the default, the issuer printed a 3-year RMB1bn mid term-note on 20 Oct 2020 with a coupon rate of 6%. There had been no pre-warning from onshore rating agency and the company had over RMB40bn of cash as of 3Q. In total, the company has RMB24bn of onshore bonds outstanding and its parent company, Henan Energy and Chemical Industry Group, has another RMB25.5bn. If all of these bonds default, it would represent the largest default case on

Suites 3503 - 3504, 35/F, Cambridge House, Taikoo Place, 979 King's Road, Quarry Bay, Hong Kong
香港鰂魚涌英皇道979號太古坊康橋大廈35樓3503至3504室
T 電話 (852) 2169 2100 F 傳真 (852) 2869 6991 www.incomepartners.com

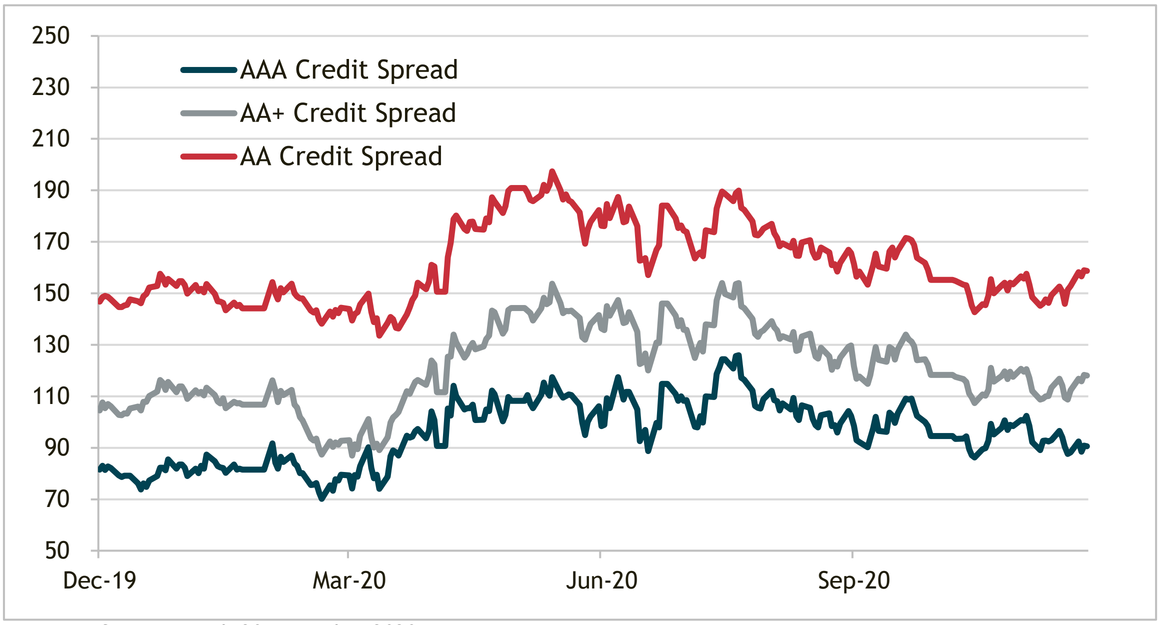
the onshore bond market so far, surpassing Peking University Founder Group's record. To investors' great dismay and suspicion, it was revealed that, similar to Huachen Automotive Group, the issuer transferred its holdings in a listed bank one week before it defaulted.

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, 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.

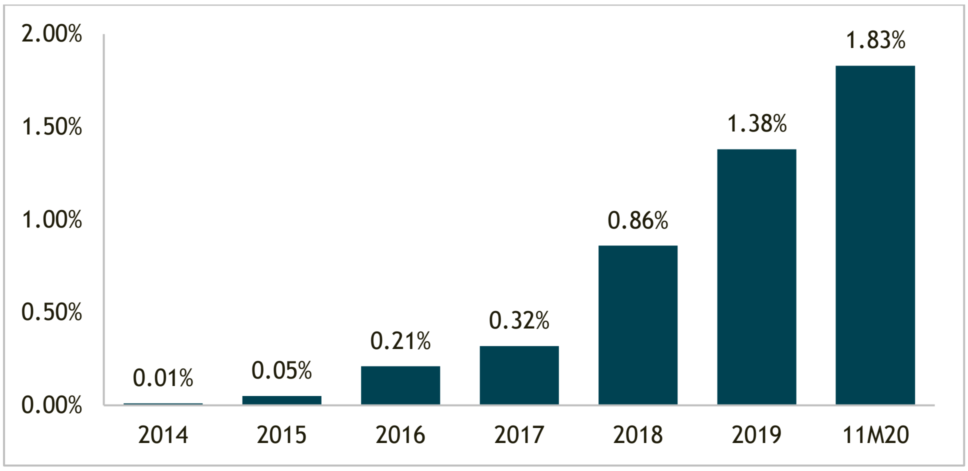
In addition, we do not consider the recent defaults pose systemic risk due to (1) China's YTD onshore default rate is still low at 1.83% even under the impact of recent pandemic, which shows the resilience of China's economy; (2) With much lower Debt/GDP ratio than Developed Markets, Chinese government and central bank have the resources and power to contain systemic risks, if any; Central Government's response to recent credit market volatility was rather swift. The Financial Stability Commission, which has an oversight above all major Chinese finance regulators, quickly convened to discuss the situation and warned SOEs/local authorities not to deliberately evade debt obligation. The fast reaction resembled that after the Baoshang Bank failure in 2019. (3) Only selective local SOEs are with weak fundamentals. There are many more strong credits in sectors such as utility, consumer, manufacturing, etc.

Credit Spread in China Onshore (bps)



Source: Wind, 30 November 2020
Representative index: CFETS AAA, AA+ and AA rated 5-year MTN Indexes

China's Onshore Default Rate



Source: JP Morgan, 13 November 2020

Investors should be prepared for the return of SOE debt reform which may lead to further spread normalization among weak SOEs

Recent events may finally be the beginning of the long overdue repricing of weak SOEs. Although the SOE credit space is regarded as too big to fail, it has been on the central government's agenda for a few years now that SOEs should deleverage and zombie enterprises should be let go. The 2018-2019 US-China trade war and 2020 COVID shock have complicated the execution of this agenda, but we don't think the policy goal has changed. In fact, while emphasizing zero tolerance for systemic risk and ill-intent in debt evasion, the government still encourages orderly SOE debt reforms and legal exits of legacy borrowing that are non-compliant. Such a long term trend, in our view, has not changed and is consistent with the government's goal to instill more fiscal discipline into local governments, SOEs and State Owned Banks.

Good investment opportunities in onshore investment grade bonds if the repricing continues

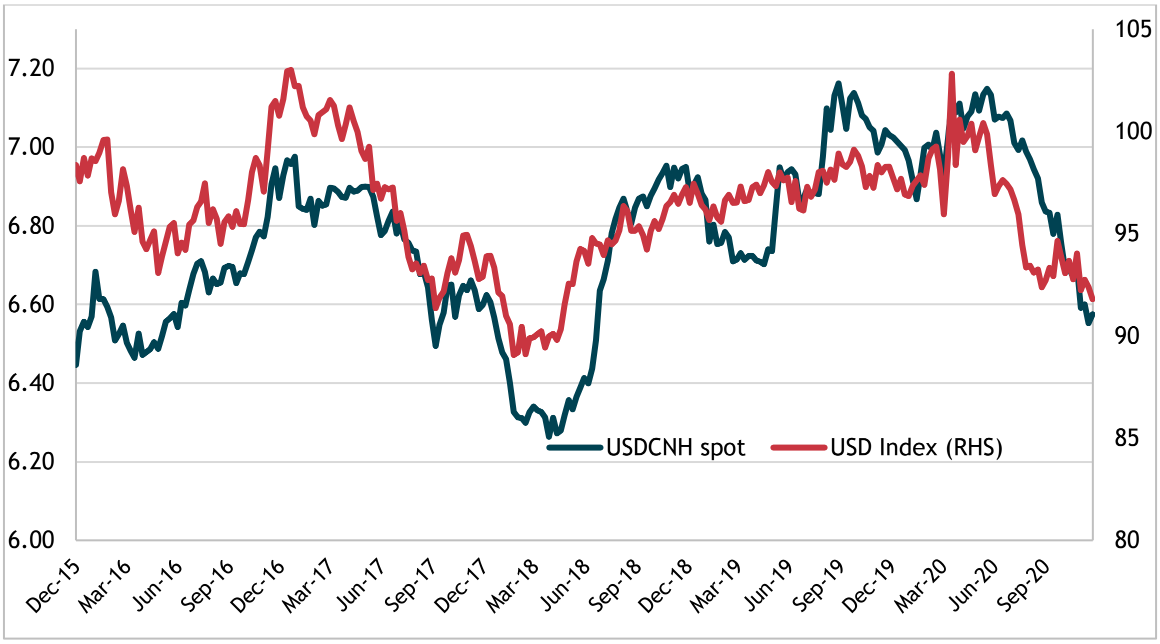
For Chinese credits, typically only central SOEs or strong private companies (such as Tencent) can be rated investment grade by international rating agencies as corporate ratings are capped by China's sovereign rating A+. Unlike high yield, Chinese investment grade have been trading closely between onshore 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.

RMB PERFORMED STRONGLY IN WEAK DOLLAR ENVIRONMENT

Remain Constructive in the Medium Term

Since our September quarterly report, RMB has appreciated approximately 3.85% against USD, and the CFETS RMB index, a gauge of RMB against a basket of tradeweighted currencies, gained approximately 2.21%. Our strong RMB call was predicated on a broadly weak USD environment, China's better recovery from the pandemic and resilient fundamentals, as well as the yield differentials. We believe these factors remain intact and, therefore, maintain our constructive RMB outlook in the medium term.

RMB vs Dollar Index

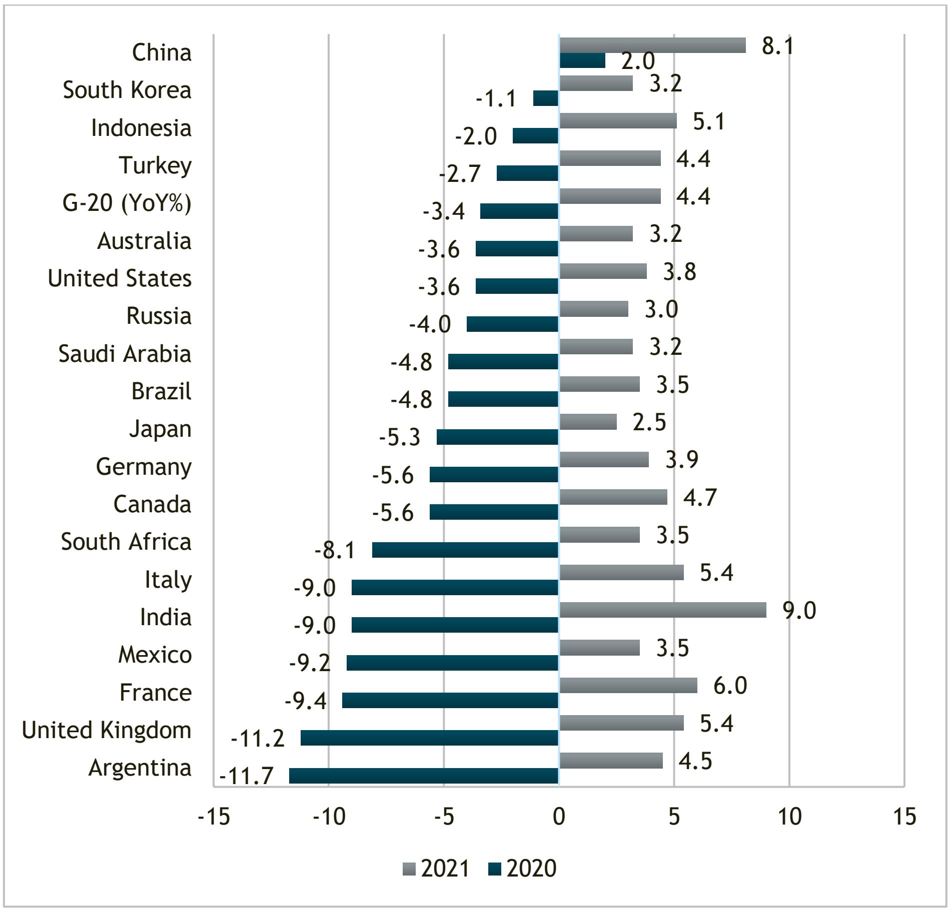


Source: Bloomberg, 30 November 2020

The Fed has signalled that interest rates will stay low through at least 2023, and will tolerate periods of higher inflation while the labor market and economy heal. Even with a vaccine later this year and a renewed fiscal stimulus package early in 2021, we think the Fed will keep asset purchases and the forward guidance accommodative. Low US interest rates, a global economic recovery and better risk appetite shall direct flows out from the US and thus weigh on the greenback, in our view.

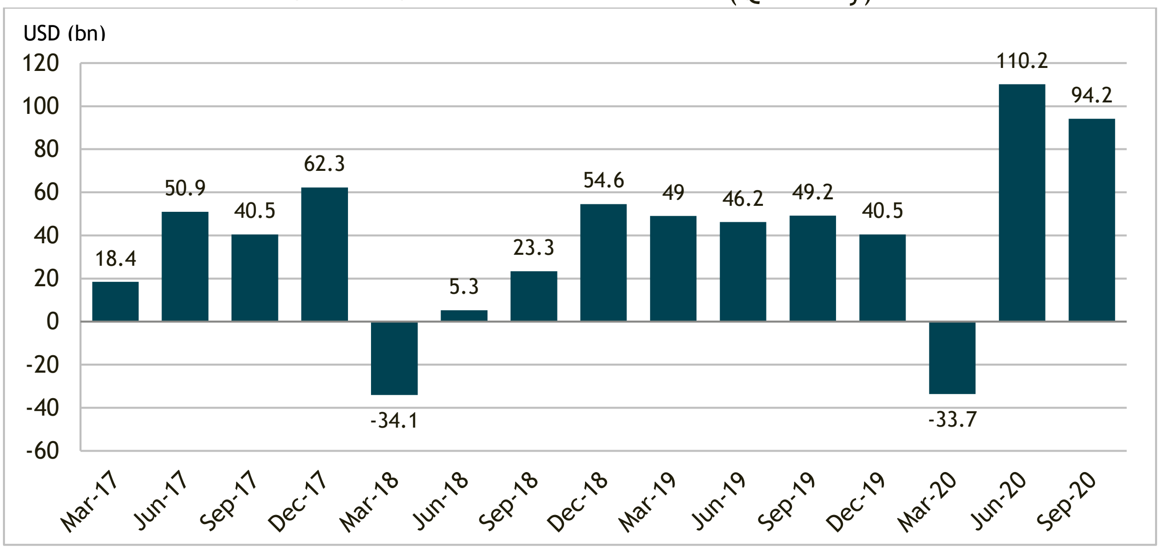
On the economic front, China manages to maintain positive real GDP growth in 2020 thanks to effective containment of the pandemic, resilient domestic consumption and better-than-expected export. The pandemic and ensuing lockdowns have hit global supply chains severely, and subsequently caused some orders and production redirected to China. As a result, China's current account surplus stayed elevated in 3Q2020 (see chart below). We expect global trade to recover together with economic rebound in 2021, which will continue to benefit China's export and growth.

Real GDP (%) Forecast for 2020 and 2021



Source: Bloomberg <ECFC>, December 2020.

China's Current Account Balance (Quarterly)



Source: WIND, December 2020.

Last but not least, the large yield differential between China and US has changed little since 2Q2020. It not only results in the different approaches the two countries adopted during the pandemic and their economic consequences, but also serves as a tailwind for RMB's rally.

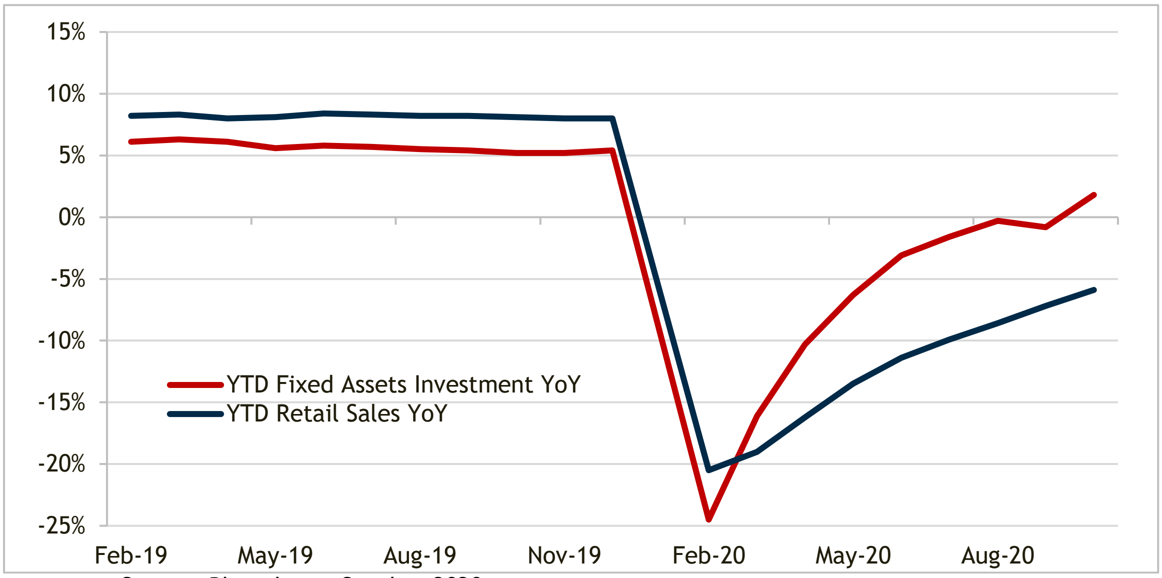
Based on these observations, we maintain our constructive outlook on the RMB. Risks to our call include dampened global risk sentiment due to a worsening pandemic situation in US or a delay of the fiscal stimulus package.

ONSHORE RATES RECOVERED TO PRE-PANDEMIC LEVEL

Defensive Near Term, Rally Opportunity Medium Term

Since May, China's onshore 10y Chinese Government Bond (CGB) yield has been on a rising trend, mainly due to the steady recovery of China's economy, heavy supply of onshore rates bonds, as well as global risk-on sentiment. In the near term, we remain defensive as the economic recovery continues, and the 10y CGB yield is technically still in a bearish trend.

Quick Rebound of China's Economy



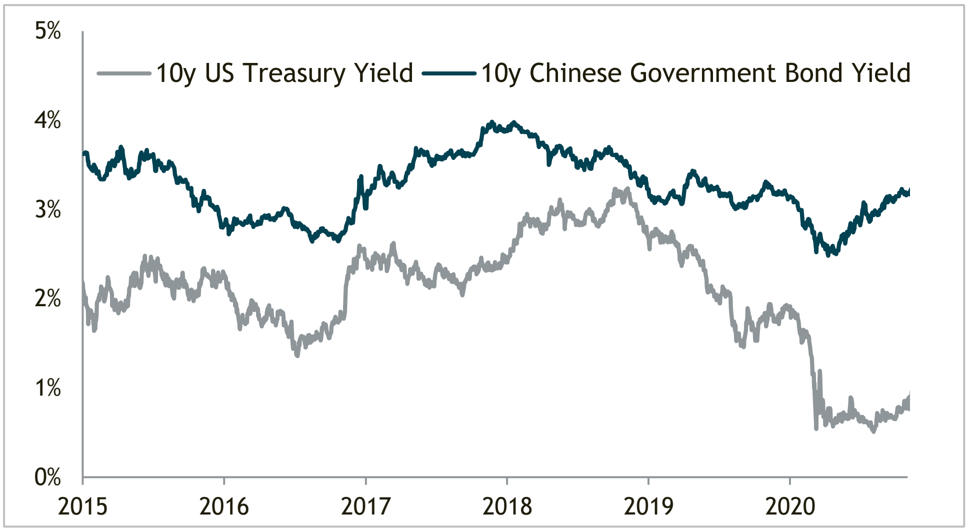
Source: Bloomberg, October 2020.

However, in the medium term, we believe we are getting closer to a turning point with potential rates rally opportunity given that: (1) the 10y CGB yield has fully recovered to pre-pandemic levels, and has priced in a lot of positive fundamentals already; (2) so far the recovery of China's economy is not balanced and more toward government led investment. For example, the YoY growth of China's YTD fixed asset investment has already recovered to +1.8% in October, compared to the pre-pandemic level of +5.4% in last December; however, the YoY growth of China's YTD retail sales only recovered to -5.9% in October, compared to the pre-pandemic level of +8.0% in last December. Therefore, there is a risk that we might begin to see some softness in economic growth going into next year, as the spillover effect from investment into consumption has not been strong enough so far; (3) the strong YTD performance of China's exports, which grew +11.4% YoY in October, will become a high base for comparison next year.

Moreover, the spread between 10 year Chinese government bond and

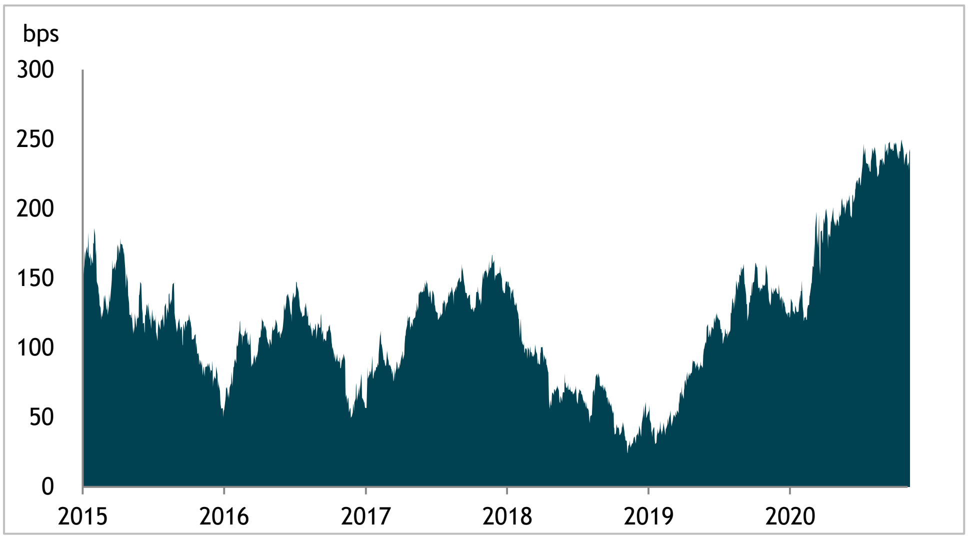
US Treasury has approached historical wide, providing attractive entry level amid the low-yielding environment globally.

10-Year Government Bond Yields



Source: Bloomberg, 30 November 2020.

Spread between 10y Chinese Government Bond and US Treasury



Source: Bloomberg, 30 November 2020.

DISCLAIMERS & IMPORTANT INFORMATION

This report is issued by Income Partners Asset Management (HK) Ltd. ("Income Partners") and has not been reviewed by any regulatory authority. It is not intended as an offer, solicitation, advice or recommendation to buy or sell any securities or any products. This report may not be received by and is not intended for any U.S. Person other than a U.S. Person who is an "accredited investor" as defined in Regulation D under the U.S. Securities Act of 1933, a "qualified purchaser" as defined in the Investment Company Act and the regulations thereunder, and "qualified eligible persons" as defined by the U.S. Commodity Futures Trading Commission ("CFTC") Rules and Regulations or the rules and regulations thereunder. This report is for distribution only under such circumstances as may be permitted by applicable law. Nothing in this report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances or otherwise constitutes a recommendation. It is provided to you solely for information purposes only. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein, nor is it intended to be a complete statement or summary of the securities, markets or developments referred to in the report. We have prepared this report without consideration of the investment objectives, financial situation or particular needs of any investor. You should consider your own investment objectives, financial situation and particular needs before taking any action with respect to a financial product referred to in this presentation. In particular, we are not acting as your adviser or assuming any duty of care in this respect. To the extent permitted by applicable law, none of Income Partners, its affiliates, or any officer or employee of Income Partners, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents, including for negligence. Investments involve risk. Under some market conditions it may be impossible to liquidate a position. Losses incurred in trading can be substantial.

- Investment in the China market is subject to emerging market risk including political, economic, legal, regulatory and liquidity risks.
- Investment involves risk. Past performance is not a guarantee or a reliable indicator of future results and no guarantee is being made that similar returns will be achieved in the future.
- In making investment decisions, investors should not rely solely on the information in this document and should read relevant offering document for further details including the risk factors. This document does not constitute an offering document.
- Index or benchmark data are for reference purposes only and no comparability or relevance is warranted or implied. Care should be taken as the composition, volatility, duration, yield and other features may from time to time be materially different from the indices and the underliers of the indices. Indices may rebalance or change its composition and weighting of its underliers from time to time and no regard has been given to such changes in this document. The recipient should conduct its own research and be familiar with the characteristics and underliers of any indices.