INCOME PARTNERS

JANUARY 2022

CHINA ONSHORE BOND MARKET QUARTERLY

2021 was a rewarding year for Chinese onshore rates and investment grade strategy, with the 10-year Chinese government bond rallied by 37bps from 3.15% to 2.78%, and CNY appreciated by 2.6% against USD. On the other hand, Chinese high yield credits, especially in the offshore USD bond market, underperformed due to the sharp correction in the Chinese real estate high yield sector.

Look ahead into 2022, we expect that onshore rates will have further room to rally in the first half and may consolidate into the second half, as China's economy finally stabilizes with policy support. The RMB currency will remain relatively stable and continue to outperform major non-USD currencies. In the meanwhile, offshore Chinese real estate high yield is going to offer attractive investment opportunity, which is likely to bounce back starting second quarter due to its already stressed valuation and the government's ongoing policy fine tuning towards the property market.

RATES RALLY TREND TO CONTINUE INTO FIRST HALF

For most of 2021, China's onshore 10-year Chinese government bond was in a rallying trend mainly due to slower credit growth and the spillover effect from policy tightening in the property market. As China's economy is still facing heavy downward pressure, we believe the rates rallying trend will extend in the first half of 2022, and then consolidate from there onwards into the second half. We have summarized the major factors that will affect Chinese rates in 2022 with our analysis below.

10-Year CGB Rallying Trend Continues

Source: Bloomberg, January 2022

1) The cooled down of China's domestic property market since the second half of 2021, a result of policy tightening since late 2020, has become the most important factor weighing on China's growth. As residential property sales account for 14.2% of China's GDP in 2021, a further

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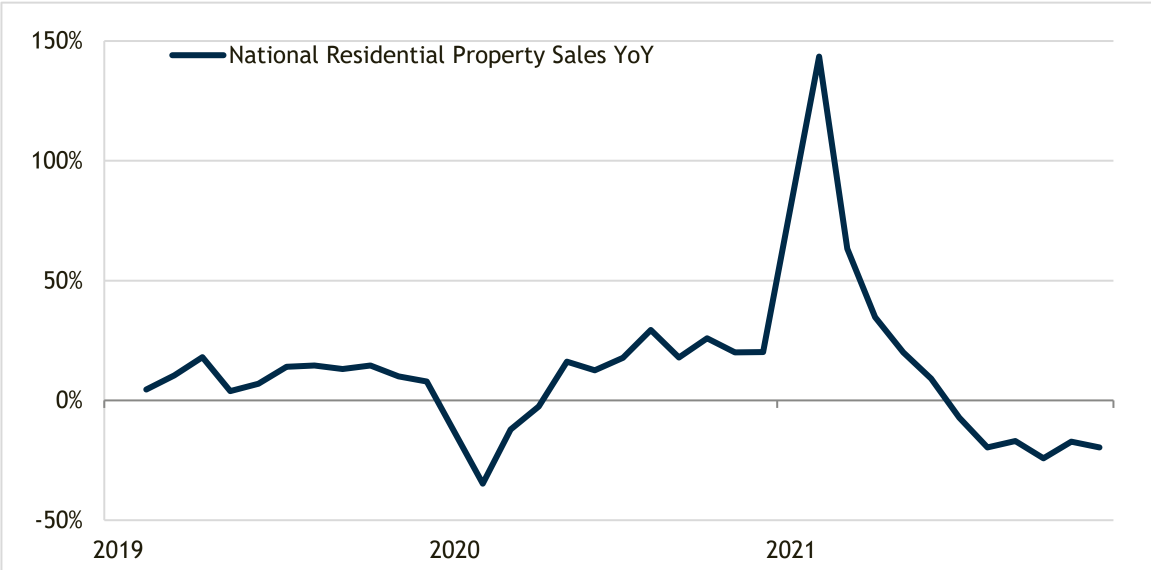
slowdown of the property market will inevitably have sizable impact on China's GDP growth this year, along with its spillover effect on household consumption and other related industries. Although there has been some policy fine tuning since last October, property sales and sentiment remain weak so far. For a material stabilization of property sales, we may well need much stronger policy stimulus, which is more likely to happen toward mid-year when the negative impact on economy becomes substantial.

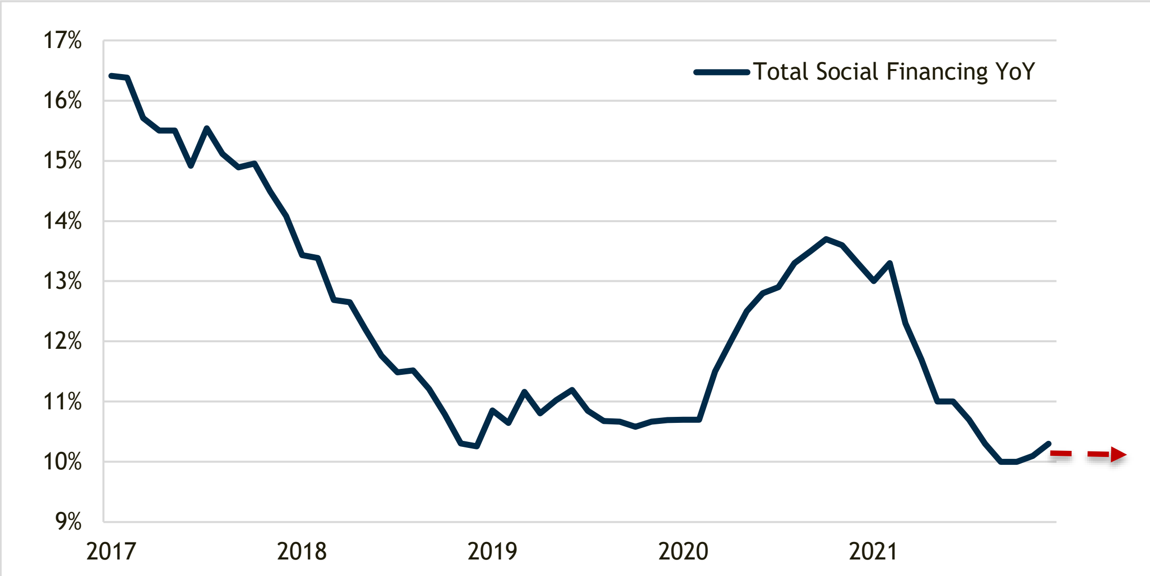
Residential Property Sales Growth Turned Negative since July 2021



Source: Bloomberg, December 2021

2) The YoY growth of China's Total Social Financing, an indicator of overall credit expansion, has shown some stabilization since last October, after deaccelerated from 13.3% in December 2020 to 10.0% in September 2021. As PBOC has repeatedly expressed the desire to match China's credit growth rate with nominal GDP growth rate (10% in Q3 2021) since beginning of 2021 in order to control China's macro leverage (Debt/GDP ratio) from going higher, we expect that, in 2022, China's Total Social Financing is likely to stabilize at the current level of around 10% YoY growth rate. Because credit growth in China typically leads the economy by 3-6 months based on past experiences, we expect to see some form of stabilization in economic growth going into the second half of the year, after the slow growth phase in 1H resulted from the lagging effect of credit slowdown Under such expectation, the rallying trend of onshore rates should have further room to go before consolidating into the second half.

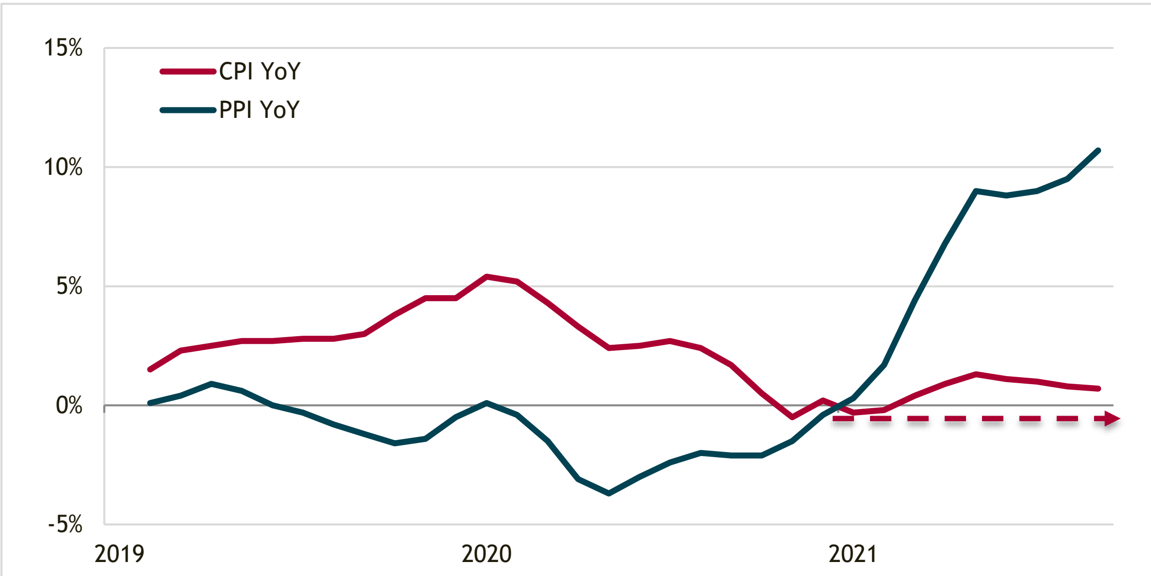
China's Credit Growth Expected to Stabilize at around 10% in 2022



Source: PBOC, December 2021

3) Inflation risk is a wild card for global interest rates, but we believe that, similar to what happened in 2021, economic slowdown will continue to override inflation fear in China as the key driver for rates during the first half. At the same time, largely because China has been a global net producer rather than importer, so far CPI inflation has been well under control in China with a low print of 1.5% in December 2021.

CPI Inflation Well Contained in China



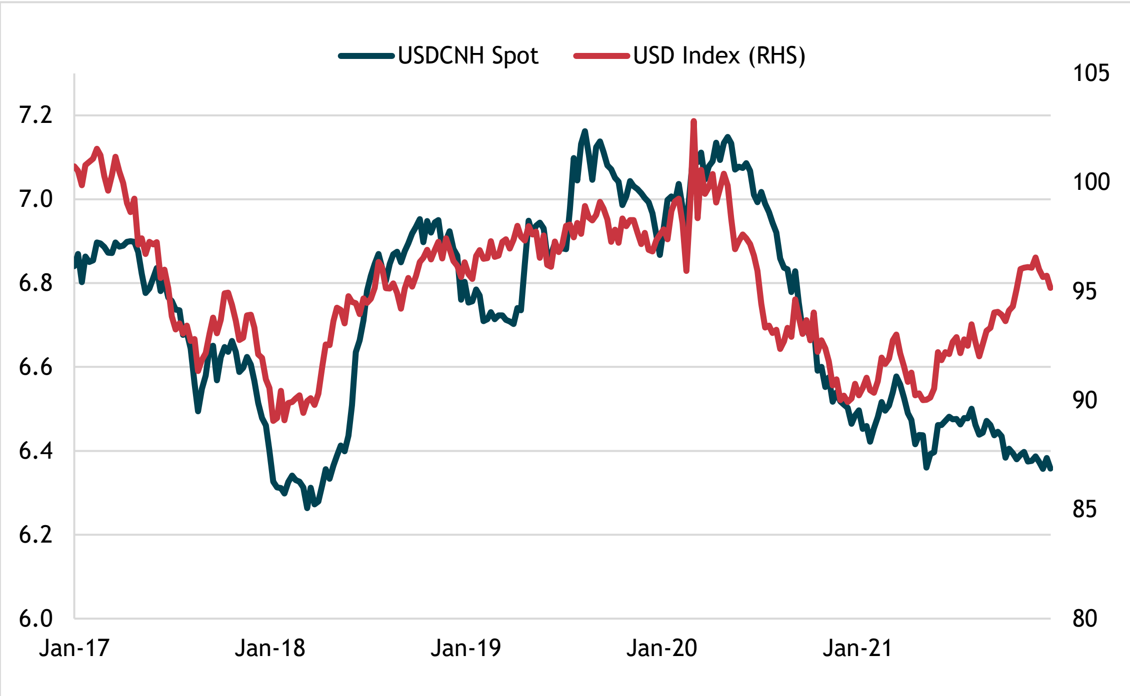
Source: Bloomberg, December 2021

In summary, we believe that onshore rates will have further room to rally in the first half before likely consolidation into the second half when more policy support on the property market and stabilized overall credit growth start to play in.

STABLE OUTLOOK ON RMB THANKS TO FUNAMENTAL SUPPORT

In the fourth quarter of 2021, the RMB continued to outperform and strengthened 1.5% against the USD. Looking ahead into 2022, although potential Fed hikes could continue to strengthen USD against major currencies, this has largely been priced in by the financial market, and the supporting fundamental factors on RMB such as more disciplined monetary and fiscal policy, strong exports helped by integrated and resilient supply chains, steady foreign inflow into onshore RMB assets boosted by global bond indices inclusions, positive real yield and the internationalization of RMB remain intact. We expect the RMB currency to remain relatively stable against the USD with a slightly higher trading range, and continue to outperform major non-USD currencies.

RMB Outperformed Major Currencies since Covid Pandemic



Source: Bloomberg, January 2022

China has delivered a CAGR GDP growth of 5.1% for the two-year period of 2020-2021, and we expect the economy to grow at 5% - 5.5% in 2022, helped by expansionary fiscal policies and more monetary easing later this year. China registered record trade surplus of USD676.4bn in 2021, with exports surging 29.9% YoY. China's exports have benefited from domestic integrated supply chains that were less affected by the pandemic. With the new Omicron wave hitting global economies, we may continue to see strong export being a strong supporting factor for the RMB in the next few months.

Strong Trade Surplus Supportive to RMB Strength

Source: Bloomberg, January 2022

OPPORTUNITY IN THE CHINESE REAL ESTATE HIGH YIELD SECTOR CREDIT

Since late 2020, the Chinese regulator has tightened policy towards the domestic property market in order to control potential price bubble, which finally resulted in funding squeeze among weaker Chinese property developers and a sharp correction in the offshore Chinese real estate high yield USD bond market in 2021. At this point, we are turning positive on the performance of the sector in 2022, and believe that Q1 could mark a potential turning point as the ongoing policy fine tuning will support sector recovery while valuation as a whole has already become attractive.

Chinese Real Estate High Yield Sector Sold off in 2021

Source: Bloomberg, January 2022

1) Ongoing Policy Fine Tuning

On the policy front, in the second half of 2021, the PBOC had already cut RRR rate twice to 11.5% to support the economy. So far in 2022, the PBOC also cut its benchmark 1-year Medium-Term Lending Facility (MLF) rate by 10bps in mid-January. With further downward pressure on the economy from the cooling property market, we expect further monetary easing in 2022.

Specific to the property market, we expect further policy fine tuning in the next 2-3 months to prevent systematic risk and support the property market and economy, which will continue to benefit Chinese property developers, especially quality ones. In fact, since October 2021, there has been positive development on developers' major sources of cash flows which could potentially improve their liquidity situation.

- **Supportive of Mortgage Growth:** In November and October 2021, the MoM increase of personal mortgage loans in China accelerated to CNY 401 and 348 billion, respectively, from CNY 101 billion in September 2021. The faster growth and approval of mortgage loans will translate into faster cash conversion from property sales for developers.
- **Supportive of Refinancing:** Some Chinese property developers, including SOEs and large private companies such as Greentown, Longfor, Logan, etc., have been able to issue CNY bonds in the onshore interbank bond market since November 2021. Furthermore, some developers such as CIFI, Powerlong, and China SCE have already tapped the offshore USD bond market.
- **Supportive of Asset Liquidation:** It was reported in early January that debts accrued from acquiring distressed assets may be excluded when calculating property developers' compliance with the "three red lines" policy. This, when implemented, will be a very positive development in our view as it opens the door for troubled developers to liquidate assets in a more timely manner to raise liquidity.
- **Easing on Presales Cash Supervision:** It was reported on 18 January that China is making new rules to allow property developers using supervised funds in presales escrow accounts to pay suppliers, finance operations and meet debt obligations. Once executed, it could potentially release cash from presales escrow accounts and improve developers' liquidity situation.

2) Valuation Already Becomes Attractive

On the valuation side, at the recent market low as of 18 Jan, the average dollar price of JACI Chinese real estate high yield sector was 65.5 cents. If we assuming average 30% recovery ratio (which is a reasonable assumption as different from manufacturing or technology sectors, in general Chinese property developers have more valuation assets on their balance sheets), the implied default rate for the whole sector was 49% in terms of dollar amount. This hasn't even included defaulted issuers such as Evergrande, Kaisa, Fantasia and China Fortune Land which have already been excluded from the index. We believe that such valuation was over bearish caused by market panic, as most of the 30+ Chinese property developers with USD bonds outstanding are top 100 developer in China. If more than half of them defaulted, it will be close to systematic risk, and that's what the Chinese authority must try to prevent from happening.

Chinese Real Estate High Yield Sector Valuation

	18 Jan 2022
Average Dollar Price	65.5
Implied Default Rate for the Whole Sector (Assuming 30% Recovery Ratio)	49%

Overall, we may continue to see price volatility in Q1, mainly caused by credit events of weaker developers. For the rest of the year, however, we expect to see a revaluation of the whole sector, as weaker developers are all out with debt exchange or restructuring plans while the rest of developers with less default risk will benefit from the policy fine-tuning and gradually recover to par.

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