PRC Macro

Macro Update: China HY Bond Rout Likely to Escalate

Non-Monetary Credit Contraction as Local Governments and Banks Retreat

May 23, 2018

In recent pieces we have proposed that the veneer of financial sector stability as a function of interest rate volatility may be only that. Actual level of risk where it comes to funding and asset quality for non-core commercial banks are probably much higher than they appear. At the same time and as proposed earlier this week, we think that unannounced financial supply side reforms are coming and will follow a similar logic to what has been seen in industrial sectors: consolidate channels of supply to improve price (interest rate) transmission and make it easier to prevent cyclical overshooting (here credit booms and busts) (see: **China Macro Monday**, May 21).

The architects behind the ongoing overhaul of China's financial system want to deliver the sector to a much more stable future, but the problem is getting there. So far, and despite a lot of rhetoric to the contrary, Beijing has taken steps to prevent financial sector pain in the form of credit defaults and insolvent financial institutions. But, short of the anesthetic effects of some form of QE, which represents the antithesis of a "macro leverage cap", there is no pain-free way to reduce leverage risks in the economy. Financial sector risks are rising in the high-yield (HY) corporate bond market, and this will be the first place to look for clues as to how the next phase of "deleveraging" proceeds.

A slew of default or near default cases of HY corporate defaults have jolted domestic markets so far this year. This involves around 20 cases and RMB 25 billion in notional principal amounts. Although this may not sound like much in the grand scheme of things, the backstories for many of these cases lay bare the kinds of conflicts and administrative lapses that have contributed to massive direct and contingent local government and local SOE liabilities. Default risks have spread to LGFVs, with several in Tianjin and Liaoning on the verge of default - both regions that have confessed to significant statistical fraud in recent years (see here for a cool paper on the "night-lights elasticity of GDP" and authoritarian statistical manipulation). There are several commonalities among these recent defaults and near misses: 1) recent defaults have been concentrated among private corporates with investment grade ratings (AA+ and AA), reflecting a deterioration of corporate credit quality; 2) private firms that have been involved in default cases are mostly "zombie companies" reliant on short-term financing (such as CP, private placement notes (PPNs) and stock pledges) to service their long-term debt, which includes both bank and shadow bank loans; 3) LGFV and SOE default risks are concentrated in regions that have recently fessed up to sharp revisions to local growth rates and tax revenues; 4) these default cases have provoked concerns of contagion risks among financial institutions (especially mutual funds and trust companies) and has eroded trust among institutional and retail investors in high-yield WMPs.

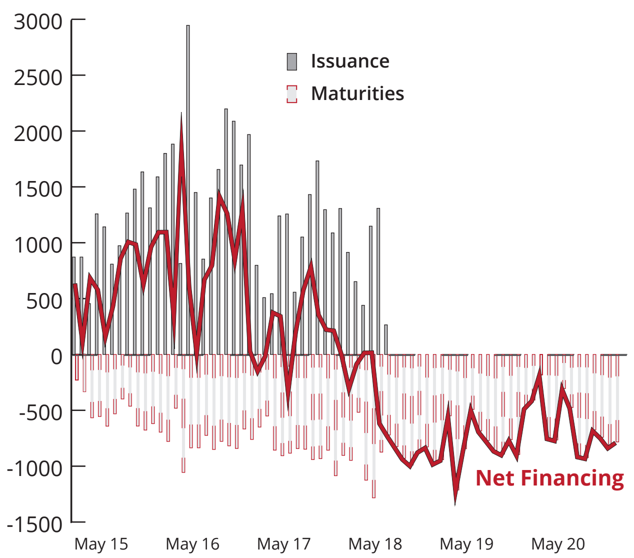
After the initial domestic market panic, this story took a dramatic turn last week as the corporate and LGFV borrowers named in several headline cases announced the repayment of their debt with bailouts from local governments. Regardless, commercial banks are continuing to recall funding from HY bonds, in part because local governments are revoking their credit enhancements for LGFVs quickly as well. As a result, we expect China's HY bond rout to continue and to re-escalate in the coming month.

Investment Implications:

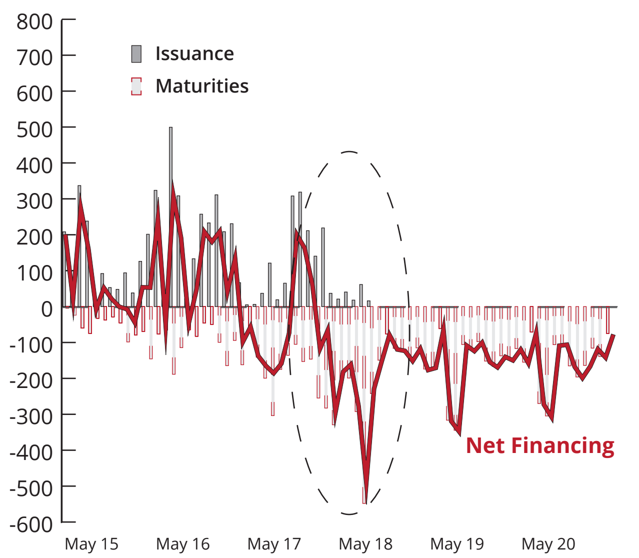
- Even with the prospect of local government bailouts and further monetary easing from PBOC in the form of RRR cuts, we expect notices of more HY bond defaults to jolt domestic markets in China (as well as foreign sentiment towards the China credit story). Domestic credit investors are in the process of repricing risk for investment and sub-investment grade bonds, and corporate borrowers will face higher interest costs as well as funding difficulties.

- Beneath the veneer of stability, we think financial conditions in China are worsening. As we have noted previously, two causes are the attempt at a "macro leverage cap" and broad-based augmented fiscal support for growth that is absorbing a large proportion of new credit being created. New corporate borrowers and those seeking to roll-over existing credit are

Corporate AA and Below: Net Withdrawals of Bond Funding Are Starting To Accumulate
Wind and PRC Macro / RMB 100 million



SOEs: Issuance of Low-Grade LGFV Bonds (AA or below) Has Ground to A Halt With Maturities Looming
Wind and PRC Macro / RMB 100 million



competing for a shrinking quantum of funds. Additionally, given that a large proportion of corporate bond issuers are also listed companies, the repricing of their credit risk should weigh on their share prices (and share prices in general).

• In terms of a policy response, we are looking for MOF (and the NDRC) to maintain a strong augmented fiscal impulse (see: **2Q18 Augmented Fiscal Spend Update**, May 18), and for PBOC to begin a series of RRR cuts starting as early as the first week of June.

• One of the triggers for actual and near-defaults is the reduction of bank funding for HY WMPs, which itself is a product of regulatory tightening.

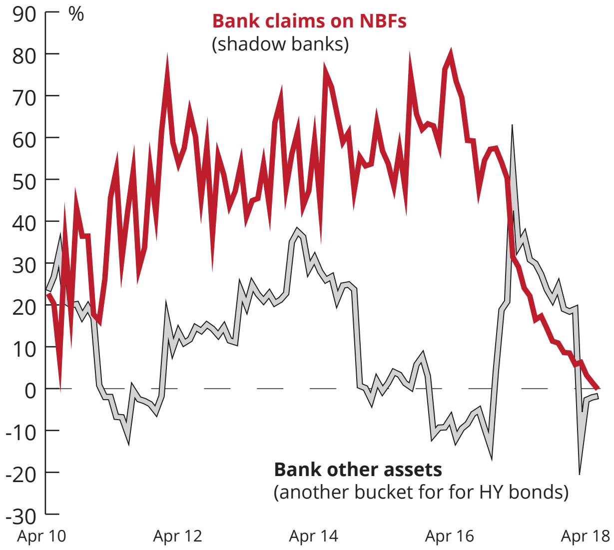
• There are significant contagion risks between financial institutions, LGFV, corporates and even local governments as a result of lax underwriting and reliance on dubious credit enhancements when the underlying liabilities were created. We see trust companies and money market funds (MMF) as most exposed to this phase of the deleveraging process, with developers and smaller regional banks (who have relied on their funding) also exposed.

• The latest messaging from Beijing (notably Liu He) indicates that central authorities would like to tolerate more outright corporate defaults as a means of reducing moral hazard, local government misdirection of resources and to make sure that more new credit gets directed to sectors favored by the state.

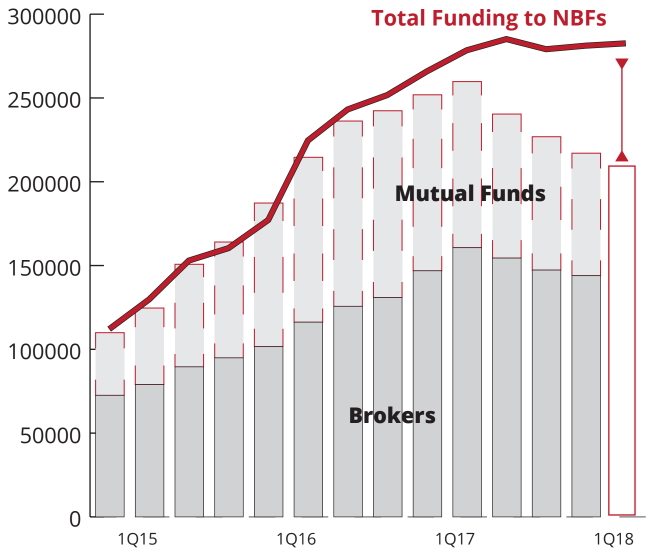
• Just last night there were new reports regarding the finalization of "The Thirteenth Five-Year Plan for a Modern Financial System" (hereafter called the Financial FYP) by the PBOC, NDRC and other concerned agencies. Whereas regulatory "documents" released to date have focused more on the categorization, accounting and provisioning for credit assets and liabilities on various balance sheets, this Financial FYP implies major changes ahead to the legal status, oversight and permitted activities of the underlying ***institutions*** involved. All in all, this adds up to what we sense is an effort at unannounced financial supply side reform, which will include a re-concentration of market share in the banking sector, as well as the absorption of the financial operations of non-financial groups, or in other words the gradual absorption of the shadow banking industry.

• Finally, it is beyond the scope of this note, but our sense is that the political momentum behind many aspects of "reform" is stalling. This is the result of lingering, tacit disagreements as to the correct balance between stronger statism and real "opening". Given that the effects of reform compound with time, there are many worried about what they see as renewed and heavy state intervention in key areas of the economy and various forms of systemic paralysis (e.g. manufacturing capex growth at 4%, instead of 20%).

Banks' Potential Channels for Funding HY Bonds Have Further Contracted
Wind and PRC Macro / YoY %



Banks Have Continuously Redeemed Funding From HY Bonds; Shifting to Trusts WMPs and Money Market Funds
Wind and PRC Macro / RMB 100 million



Default Anxiety

• There has been a wave of HY corporate defaults so far this year that has shaken the confidence of China's corporate bond investors. The magnitude of defaults YTD is only around RMB 25 billion, accounting for roughly 5% of the notional value of maturing corporate bonds YTD.

• Although the total value of defaults seems small, there are commonalities among these cases that domestic investors have seen as cause for concern. First, defaulting firms are mostly publicly listed, large private firms, which are supposed to have access to better and more diversified funding. Second, these firms carried investment grade credit ratings before the defaults occurred. Third, these defaulted bonds are believed to be widely held in WMPs funded by mutual funds and even some commercial banks, and used to be considered safe by investors.

• Some analysts have drawn analogies between recent defaults and those that occurred in early 2016. However, we think these two episodes differ in two ways: 1) the 2016 defaults were concentrated among junk bonds, whereas this time defaults have primarily involved investment grade bonds, reflecting a further deterioration of corporate credit quality; 2) the 2016 defaults were mainly limited to commodity and other upstream sectors, whereas recent defaults have been concentrated in downstream manufacturing sectors this year, which suggests credit risks have migrated downstream after supply side reforms and reflation in 2017. In other words, the distribution of profits has been narrow and concentrated upstream.

• Defaults this year have also been particularly skewed towards private firms who have failed in attempts to transform themselves from low-end to higher-value manufacturing in the last few years (such as solar panels and batteries), as well as some who have diversified into financial businesses. As a result, profit margins for core businesses remain thin, at the same time that new businesses have become increasingly vulnerable to leverage risks, lower government subsidies and tighter regulation.

• Funding in China's corporate bond market has deteriorated further this week as investors have become more risk averse. Oriental Garden, a noted private and publicly traded company that is highly dependent on local government PPP contracts, only raised RMB 50 million from a planned RMB 1 billion bond auction. The speculation is that even this RMB 50 million commitment was actually made by the firm itself to save face. Oriental Garden enjoys (ahem, bought) a AA+ issuer rating, but still failed to attract investor interest with a 7% coupon, nearly 150 bps higher than average loan rates.

• Why? Well, the company's free cash flow is reported at around RMB 2 billion, and its operating cash flow is around RMB 3 billion. However, the estimated debt maturing within 1-year for this firm is around RMB 10 billion! This means that without debt relief or liquidation of assets, Oriental Garden will be cooked. Additionally, as is often the case, whenever bond auctions fail commercial banks will rush to cut back credit lines and secure collateral.

• Also different from other private corporate defaults is that what underlies the Oriental Garden case is the expected worsening of local government funding conditions because the firm is highly reliant on local PPP contracts (and services payments from local governments as off-takers).

• Related, there have been reports that two Tianjin LGFVs have faced difficulties repaying trust loans of RMB 550 million. The parent company of these two LGFVs is owned by Tianjin SASAC, which provided guarantees for these loans as credit enhancement. Interestingly, these default rumors follow a substantial deceleration of reported growth in Tianjin, with real GDP growth falling from 9% in 2016 to 3.6% in 2017 and FAI slumping from 12% in 2016 to 0.5% in 2017.

• With market anxiety high, the default narrative took a dramatic turn late last week. Several high-profile default cases, such as Dunan and the Tianjin LGFVs, announced repayment of their maturing bond and loans with bailouts from local governments.

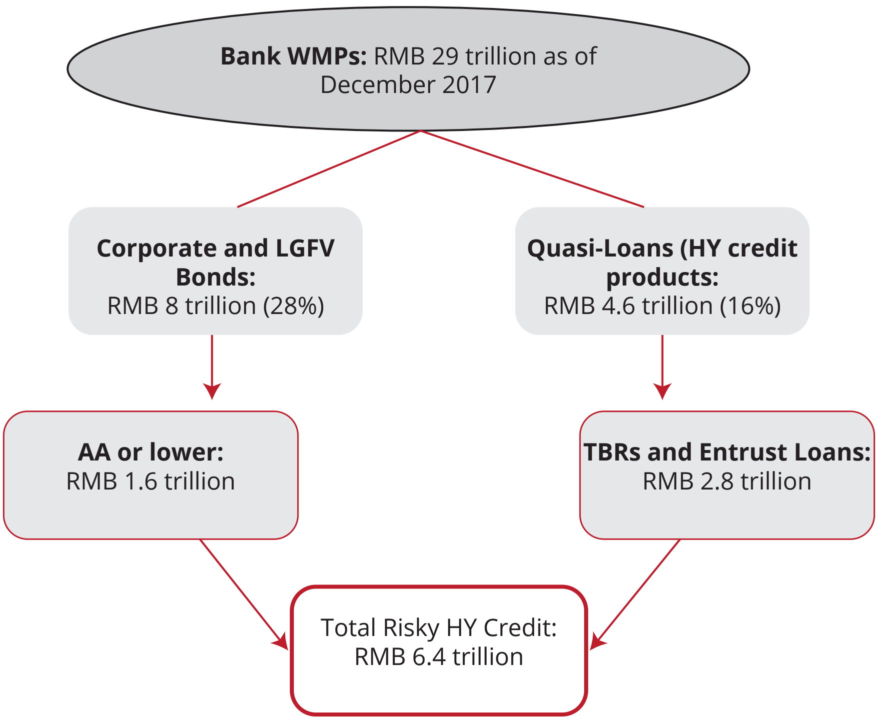
• However, our expectation is that these bailouts will only buy some time for private corporates and local governments to renegotiate terms and extend future payments with creditors. As credit quality further deteriorates, the tail risks for corporate defaults will only grow fatter, and bondholder losses will have to be realized after debt is restructured.

Why Default Now? Cash Flow, Interest Rates

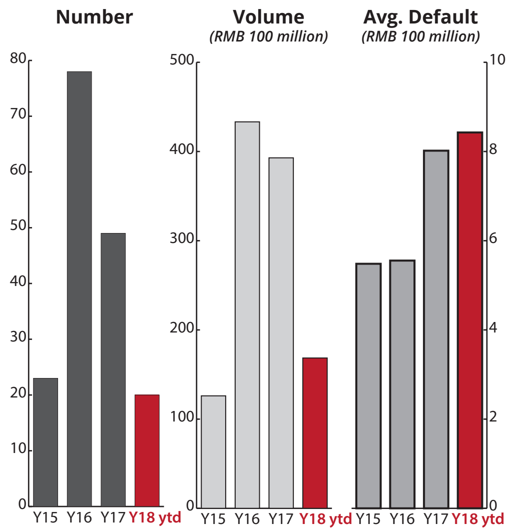
• The reason why we have grown more pessimistic about China's HY bond market risk is because defaults this year are not entirely driven by a deterioration to corporate and local government credit conditions. Politics and the feedbacks from a renewed augmented fiscal impuse are also part of the mix.

• Also, many lower-rated private corporates and LGFVs have become more reliant on issuing short-term CPs (because of relatively cheaper rates compared to MTNs and bonds) to finance their long-term investments, maturing debts and business operations.

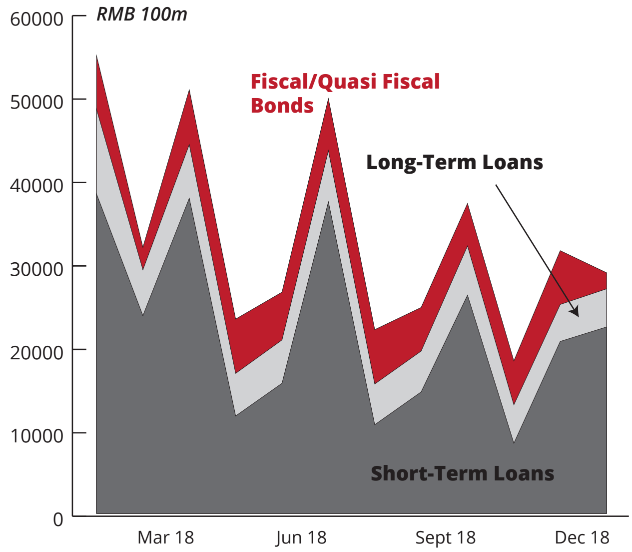
• Net financing for AA rated and lower corporate and LGFV faced a net withdrawal of RMB 30 billion in January, and conditions are worse for LGFVs as a result of slowing growth (and government support).



Reported Bond Defaults - On Pace for Record Year
PRC Macro / Wind



Estimated Credit Maturities (***Excluding Off-Balance Sheet Shadow Bank Credit***) Jump in June, July
PRC Macro / Wind



• But, the question is why default now and why not borrow more from somewhere else to keep rolling over maturing bonds? There are several reasons: 1) augmented fiscal operations are eating up a large proportion of new credit under the "macro leverage cap"; 2) commercial banks are pulling funding for HY bonds and loans as result of regulatory tightening; 3) the benefits of underlying cash flow and profits associated with reflation amount to a tax on downstream firms, hampering their cash flow; 4) the de facto rationing of available credit according to political criteria.

• Commercial banks' funding for HY bonds and loans mainly come from sales of bank WMPs, the proceeds of which are invested through non-banking financial intermediaries (such as brokers, mutual funds, and PEs), which are booked as banks' claims on NBFs. In turn, brokers and mutual funds will allocate banks' WMP funds into a variety of assets, including government bonds, equities, deposits, HY bonds, and trust and entrust loans.

• Bank lending to NBFs has contracted by RMB 1.7 trillion since January 2018 (in contrast this item actually grew by RMB 1.7 trillion in 2017), which means the total size of banks WMPs probably contracted by a similar amount. That implies that not only have banks stopped buying HY bonds and loans, they have also begun to ***redeem*** investments in HY bonds and loans.

• Bigger picture in the context of the allocation of funds raised via bank WMPs, as of December 2017 around 28% of banks' RMB 29 trillion in WMP funds were invested in AA or lower rated bonds and notes, and roughly 16% were invested in other high-yield credit products (non-tradable PPNs, trust and entrust loans and bank acceptance notes etc). So, the total size of banks' exposure to high-yield bonds and loans is at least RMB 6.6 trillion. If we only consider the riskiest part related to HY bonds and trust and entrust loans, the total holding of HY bonds and loans by banks' WMPs could be around RMB 4.6 trillion.

• In either case, banks' funding withdrawals from HY bonds and loan markets so far this year could account for 20%-30% of the contraction of the entire market.

Contagion Risks and Beijing's View on Defaults

• Who will be most vulnerable to these funding withdrawals by commercial banks? As the chart above indicates, mutual funds and brokers both still account for the lion's share of banks' WMP investments. Therefore, when a bond and shadow loan default occurs, they will be held accountable for paying it back. But, the upshot is they have also been gradually giving funds back to commercial banks, essentially recalling investments in HY bonds and loans to mitigate risks.

• The shadow banks that have not been reducing investments and lending in HY bonds and loans are: 1) trust companies, and; 2) MMFs. Trust lending has grown at a slower pace since this year, but is still elevated at 20% YoY. In contrast, the size of MMFs has grown from RMB 6.7 trillion to RMB 8.1 trillion YTD.

• Arguably, MMFs should be more resilient to credit shocks because their primary investments should be in short-term, higher-grade and more liquid government and corporate bonds. But, we believe they also hold some HY CPs issued by publicly listed companies.

• Supposedly, trust companies are the most vulnerable to credit shocks because most of their holdings are illiquid and relatively long-term credit products and loans. As of December 2017, RMB 2.6 trillion of trust-based products were still funded by bank WMPs, which accounted for 30% of trust companies' total lending. In one of the Tianjin LGFV near default cases, CITIC trust was reportedly a major creditor.

• As for Beijing's attitude towards recent defaults, regulators are trying to tolerate more cases of default in order to force investors and banks to become more vigilant. Vice PM Liu He said the direction of future regulatory reform is to "let investors understand investment comes with risks, and borrowers understand that debts should be repaid."

• However, as recent cases show, we remain skeptical as to the number of defaults Beijing may tolerate, or image-conscious local officials will allow given the negative light it shines on their fiefdoms. The end result should be differential treatments for SOEs and private firms where it comes to future bailouts, with more resources continuing to go to the former, and more forced deleveraging in store for the latter.