eastspring investments

A member of Prudential plc (UK)

CHINA'S DEBT MOUNTAIN

THE UPHILL MARCH AHEAD

China's sizeable debt continues to be a major bugbear for the investment community. Lack of clear and definite policy action to address this issue have triggered fears of a potential banking crisis. While such worries are understandable it is equally important to recognise that measures to rein in financial leverage have to be delicately balanced with the need for sufficient growth. A new team of leaders to be appointed in the coming 19th National Congress Meeting will have to scale this challenge but, in true Chinese fashion, it will likely be done in a controlled manner without severely derailing the economy.

DISSECTING THE DEBT MOUNTAIN

China's total debt-to-GDP ratio crossed the 250% mark as at the end of 2016. Most of this increase has been in the corporate sector, particularly State Owned Enterprises (SOEs), while government and household debt-to-GDP ratios have remained relatively stable (Fig.1).

The growing corporate sector leverage is a concern. Debt servicing is becoming less affordable especially since nominal output growth has lagged. Why has this happened? Significant funding was channeled to sectors that already had excess capacity. Producers lost pricing power from late 2014 to mid-2016[3] as a result of idle capacity. Industrial profit growth too was subdued during this time, with SOEs experiencing the brunt of the profit declines (Fig. 2). This misallocation of

Fig. 1: Total debt-to-GDP of China[1]

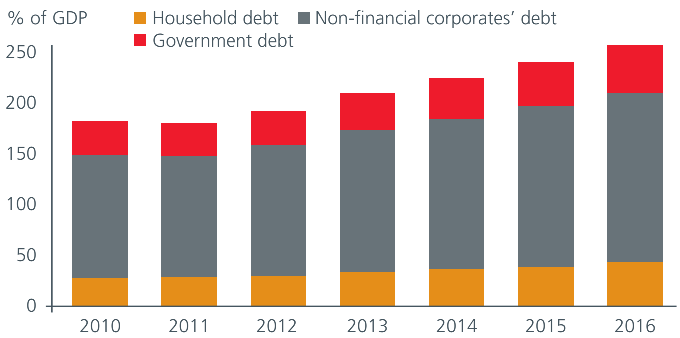
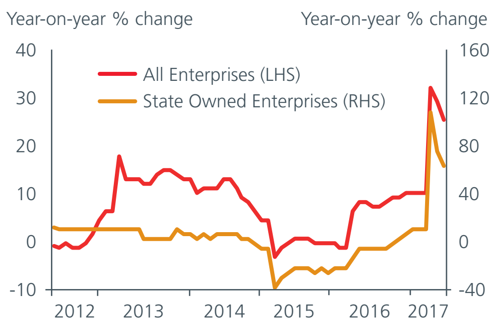


Fig. 2: China's industrial profits[2]



resources not only weighs on growth but can also lead to a sharp jump in non-performing assets and possibly trigger a financial crisis.

NO SIGNS OF AN IMMINENT CRISIS

The official non-performing loan (NPL) ratio of Chinese banks was just a modest 1.7% as at March 2017[4], but it is generally believed that NPLs are under-reported. A more meaningful picture can be derived by adding the Special Mention loan ratio of 3.8% but the NPL situation is further complicated by medium and small banks' substantial investment receivables, a significant portion of which is just lending in another form. There is little transparency on the quality and impairment provisions of these receivables.

Still, a number of supportive measures suggest that a banking crisis is not imminent. First, China's high national savings rate provides more than enough funding for its domestic investments[5]. Second, its debt problem is largely an internal one and not at the mercy of the international capital markets. Third, capital controls help to prevent the exodus of capital. In fact, these factors have allowed China to maintain accommodative monetary policies for years without significant backlashes. Last, but not least, the government, and not the heavily-indebted SOEs, is still the major shareholder of most banks in China. As the government controls both the debtors and creditors, it can prevent the debt problem from spinning out of hand.

REMAIN COGNISANT OF THE RISKS

These mitigating factors alone, however, cannot fend off a crisis forever. China's aging population suggests the savings rate may gradually decline to insufficient levels to fund investments. Furthermore, porous capital controls suggest that significant capital flight can be a potential destabiliser while the rise in credit (mostly in wealth management products) through the shadow banking sector (Fig. 3) could weaken the government's control over the debt problem.

TAKING ACTION – SLOWLY BUT SURELY

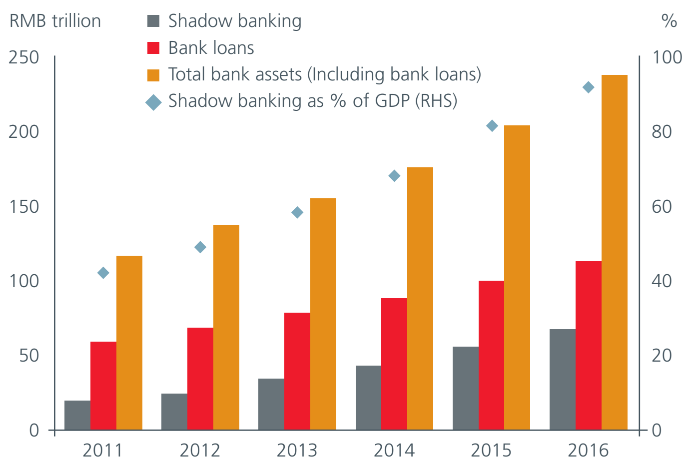
Chinese authorities are well aware of the risks. They have been working on capacity rationalisation in industries with serious excess capacity issues, and even let some unviable players go bankrupt. The reforms have borne some fruit; China's producer price index has returned to positive growth and corporate profits have rebounded strongly in 2017 (Fig. 2).

Capacity rationalisation aside, they recognise that deleveraging and reining in excessive credit creation, particularly in the shadow banking sector, are just as important. Since early this year, they have capitalised on the buoyant economic performance to implement some serious deleveraging efforts. As a result, growth in wealth management products has slowed down considerably, onshore funding costs have gone up and the onshore bond issuance volume has dropped in recent months.

REFORMS IMPACT BOND MARKETS[6]

These reforms have led to a surge in the onshore debt default amounts (Fig. 4), albeit from a low base. Nonetheless the default rate is probably still quite low - way below 1% (based on the estimated total onshore corporate bond market capitalisation). The onshore defaults are mostly

Fig. 3: Shadow banking in China[7]



in cyclical sectors suffering from excess capacity with SOEs accounting for almost half of it.

In contrast, there has been limited impact on the offshore corporate bond market; the default rate has remained largely modest and steady. 2015 was an exception; the default of a particular property developer pursuant to political fallout caused the upsurge. Offshore defaults stem from cyclical sectors, but mostly from private sector companies.

Not surprisingly, credit spreads have widened in the onshore market which has prompted greater credit differentiation. On the other hand, there been little credit spread widening in the offshore market partly due to favourable technical factors. Higher yields in the offshore market, enhanced by a potential weaker renminbi, boost onshore Chinese investors' demand for offshore Chinese bonds while suppressing supply as issuers prefer to issue bonds onshore.

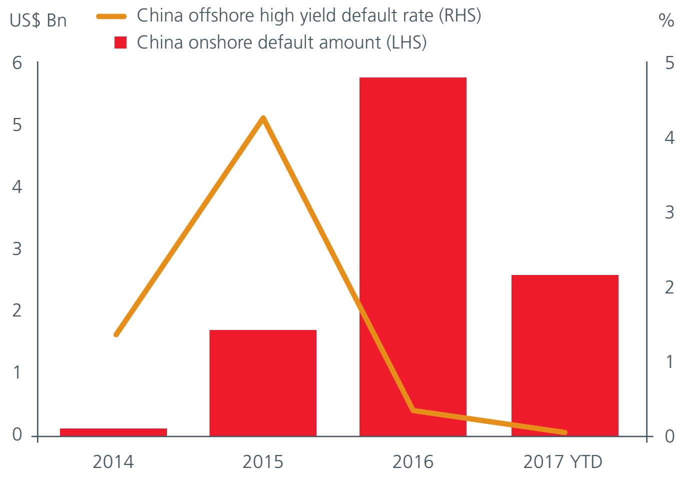
Other fundamentals such as composition and quality also favour the offshore market over the onshore one. Bond issues from quasi-sovereigns and financial sector (mainly the big four banks) together make up more than half of the offshore market issuance. Meanwhile the onshore market sees more issuers from the cyclical and over-capacity sectors. The offshore market too boasts better credit quality; over 70% are rated investment grade with more than 40% rated Single-A and/or above. In the onshore market, nearly half would be considered low investment grade or high yield by international standards.

More recently, weaker Chinese high yield names have been tapping the offshore market, taking advantage of the buoyant market sentiment. There are also growing numbers of local government financing vehicles with fragile stand-alone credit profiles coming to the offshore market, capitalising on the firm perception of the market (and rating agencies) that the government will stand by these vehicles.

CHINA BOND INVESTORS MUST BASE THEIR CONFIDENCE ON A FEW BELIEFS

The Chinese government has considerable control of its domestic economy. Its ability to maintain control through fiscal and monetary policy is high,

Fig. 4: China's onshore and offshore debt[8]



whether it is forestalling a debt fallout or a banking crisis. Central government debt levels are also relatively low. Given the long term primary aim of becoming a high income country, growth is still the priority. These growth targets would be pursued without things going awry. Generally, this has been China's experience through the past ten years.

China is also expected to focus on financial stability and push reforms in a sensible way. To this end, onshore defaults will continue to rise, but the authorities will likely ensure this is done in a controlled manner, with the casualties coming from the weaker players in the excess capacity sectors. The risk is more idiosyncratic or sector-based rather than systemic. The impact is expected to be more moderate in the offshore market.

All said, China's problems cannot be denied. But as global investors, we cannot afford to ignore the growing investment opportunities in China's rapidly developing and steadily internationalising bond market. For now, our strategy is to take advantage of value opportunities on sell-offs.

Ooi Boon Peng
Chief Investment Officer, Fixed Income
Eastspring Investments

Sources: [1]IIF and Moody's, June 2017. [2]National Bureau of Statistics and Bloomberg, May 2017. [3]National Bureau of Statistics and Bloomberg, May 2017. [4]China Banking Regulatory Commission, March 2017. [5]Moody's, June 2017. [6]All supporting evidence referenced from WIND and J.P. Morgan Feb 2017. [7]Moody's, May 2017. [8]WIND and J.P. Morgan, June 2017.

eastspring investments

A member of Prudential plc (UK)