

What's behind China's falling corporate bond yields?



Janet Lu

Head of Fixed Income
Eastspring Shanghai

Despite the recent volatility in the Chinese equity markets and the rout in the global bond markets, the yields on China's onshore corporate bond market remain at historical lows. An understanding of local dynamics can help investors seize the unique opportunities in China's bond markets, while fully appreciating the risks that reside.

The continued challenges confronting China's property market and property bonds have raised investor concerns over the bonds issued by China's Local Government Funding Vehicles (LGFV). LGFVs are set up by the local governments and primarily engage in financing, investing in and operating local public infrastructure and social welfare projects (public policy projects). While LGFV bonds are technically corporate bonds, investors typically price in some form of implicit support by the local governments.

The slowdown in land sales has led to a decline in the land transfer fees to the local governments, which historically have accounted for more than 90% of local government funds and are an important source of local fiscal revenue. In addition, some LGFVs have participated either directly or in partnership with private property developers, in real estate projects, and are also affected by the weaker property sales. The woes of China's property market have weakened the ability of local governments to support the

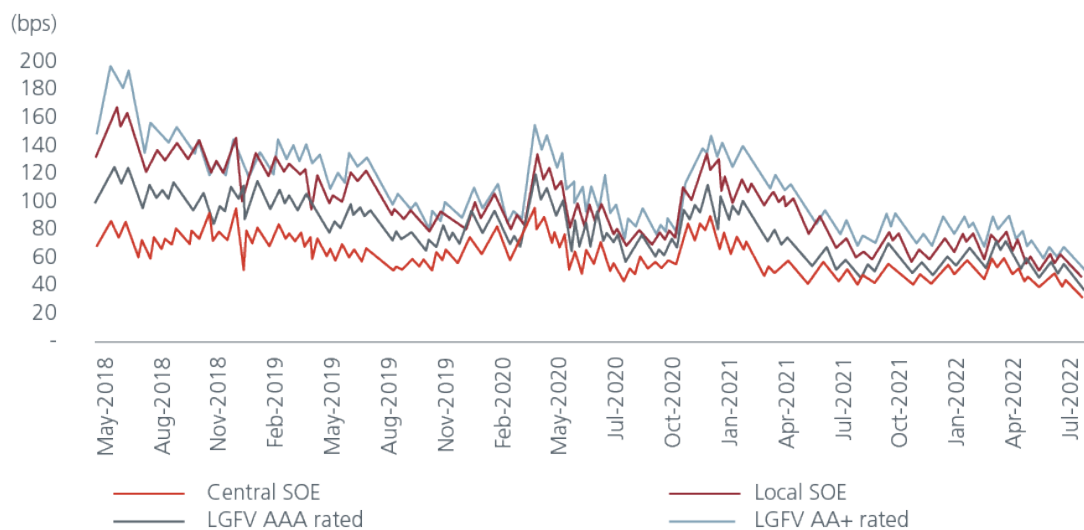
LGFVs, as the shortfall between their fiscal revenues and expenditures rises. In view of this, investors would need to differentiate between the bonds issued by LGFVs in regions with varying financial strength.

One would expect the spreads of the LGFV bonds and that of China's corporate bond market to widen on the back of China's troubled property market and overall growth concerns, but the reverse appears to be happening. While the 10-year China government bond yields have range traded in the last few months, the yields of higher quality LGFV and government-linked bonds have trended lower. Fig. 1. Overall, the yields of China's onshore corporate bonds are at historically tight levels. Fig. 2. This has helped to underpin the performance of China's onshore corporate bond market.

This phenomenon reflects the significant amount of liquidity that is residing in China's interbank system, as banks remain reluctant to lend to private companies and credit-worthy borrowers stay cautious. The People's Bank of China keeping monetary policy easy while other central banks are busy tightening has also helped.

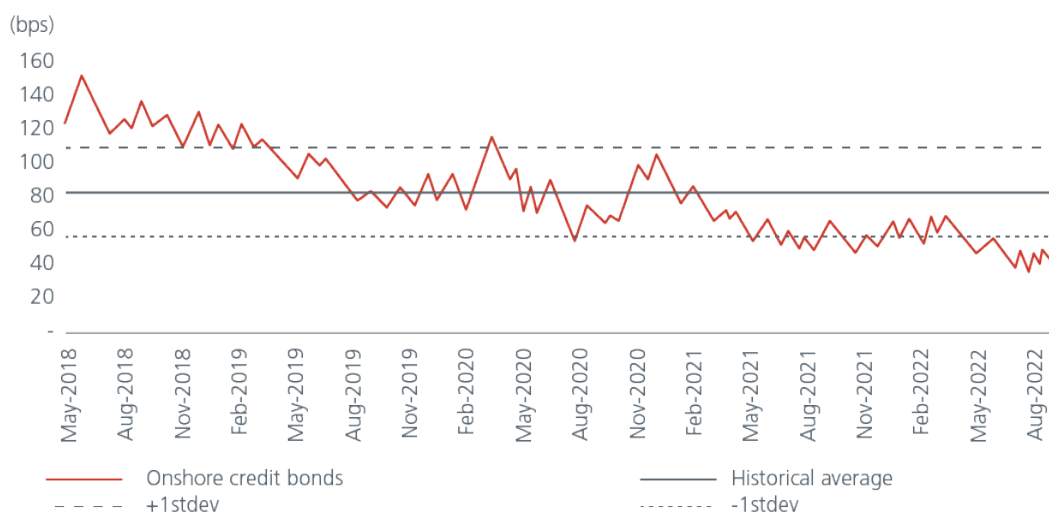
As onshore bond spreads tighten, domestic investors, including banks' wealth management subsidiaries, insurance companies, etc. have turned to the offshore

Fig. 1. High quality corporate bond yields have trended lower



Source: Wind. September 2022.

Fig. 2. Onshore credit yields are at historical lows



Source: Wind. September 2022.

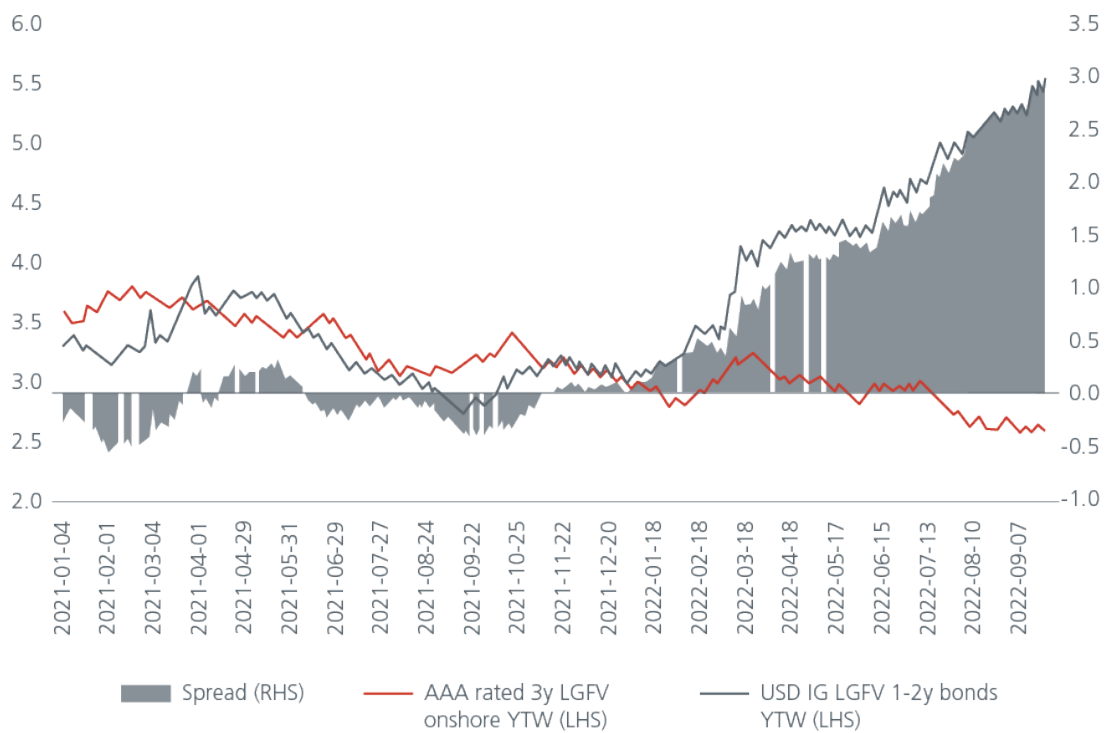
LGFV bond market, where the USD denominated bonds offer a higher yield pick up over their local currency counterparts. Fig. 3.

Amid healthy demand, supply is relatively tight in the dollar LGFV bond market due to the higher costs of financing arising from higher Fed rates. Tight supply would be positive for the prices of the existing bonds. That said, local knowledge and credit differentiation are important in accessing the dollar LGFV bond market given the lower liquidity and un-rated status of many of the issuers. In

addition, investors often need to make a judgement call on the potential level of implicit government support – municipal, provincial or central, which would have significant bearings on the bond prices. For these reasons, many foreign investors may choose to forgo the opportunities within the offshore LGFV bond market.

As highlighted above, while uncertainty remains over China’s macro environment and policy making, there will be tactical opportunities in China’s onshore and offshore bond markets for active managers. We expect China’s

Fig. 3. Dollar LGFV bonds offer a yield pick up



Source: Haitong Securities. September 2022.

monetary policy to remain loose, although we believe that the odds of another policy rate cut this year have fallen. In our view, a cut to the Reserve Requirement Ratio is more likely if China’s economic recovery remains subdued.

We remain defensively positioned in duration and look for new opportunities while rebalancing out of our local government bond trades.

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