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Credit risk for China-domiciled companies reaches its highest level since 2018

by Luo Weixiao

As China's economy is experiencing its slowest growth since the Chinese economic reform in the 1970s, the People's Bank of China (PBOC) has implemented several expansionary monetary policies to boost its economic growth such as by cutting its key loan rate in Nov 2019 for the first time since 2016. Despite the stimulus, China still reported a lower-than-expected GDP growth of 6% in Q3 2019 and faced an increasing number of bond defaults. As of early Oct 2019, the number of defaulted bonds has reached 120 - the exact same number as in the full year of 2018. In the last quarter of 2019, analysts are expecting more defaults to come compared to the previous three quarters against the backdrop of a gloomy economy.

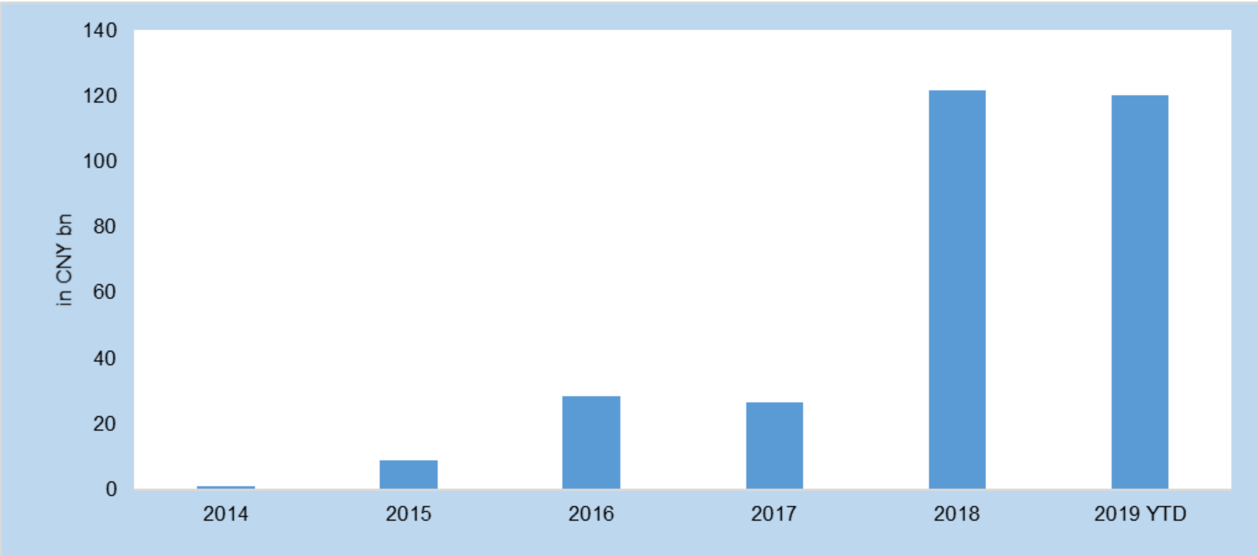

Figure 1: Amount of defaulted onshore bonds principle in billions Chinese Yuan. *Source: Bloomberg*

The rising number of defaults is mainly due to the deteriorating credit profile of Chinese corporates amid the economic slowdown and authorities' increasing tolerance to defaults. As tracked by the NUS-CRI Aggregate 1-year Probability of Default (Agg PD) shown in Figure 2 below, China-domiciled publicly listed firms have an increasing credit risk at the aggregate level since early 2018, when the side effect of the deleveraging campaign started to appear and the US-China trade tension started. The Agg PD for all China-domiciled firms at the end of Nov 2019 stands at 45.43bps (equivalent of a BBB+ rating according to NUS-CRI PDiR[1]), a level last seen in Aug 2015 during China's stock market crash and Oct 2016 when China was still recovering from the 2015 stock market turmoil. Regulators are also more comfortable with defaults as compared to years ago. While PBOC has been injecting liquidity since Jul 2018 through monetary policies such as cutting the banks' reserve rate ratio, injecting funds into market via targeted medium-term lending facility (TMLF) and loan prime rate reform, government's outright bailout was rare. Although the market-driven effort to deal with default resolutions can help China's bond market to become better functioned, the rising defaults may impose systemic risk in the financial market.

[1] The NUS-CRI Probability of Default Implied Rating (PDiR) provides a more conventional interpretation of PDs – it translates NUS-CRI 1-year PDs to letter ratings by taking reference from the historical observed default rates of S&P's rating categories.

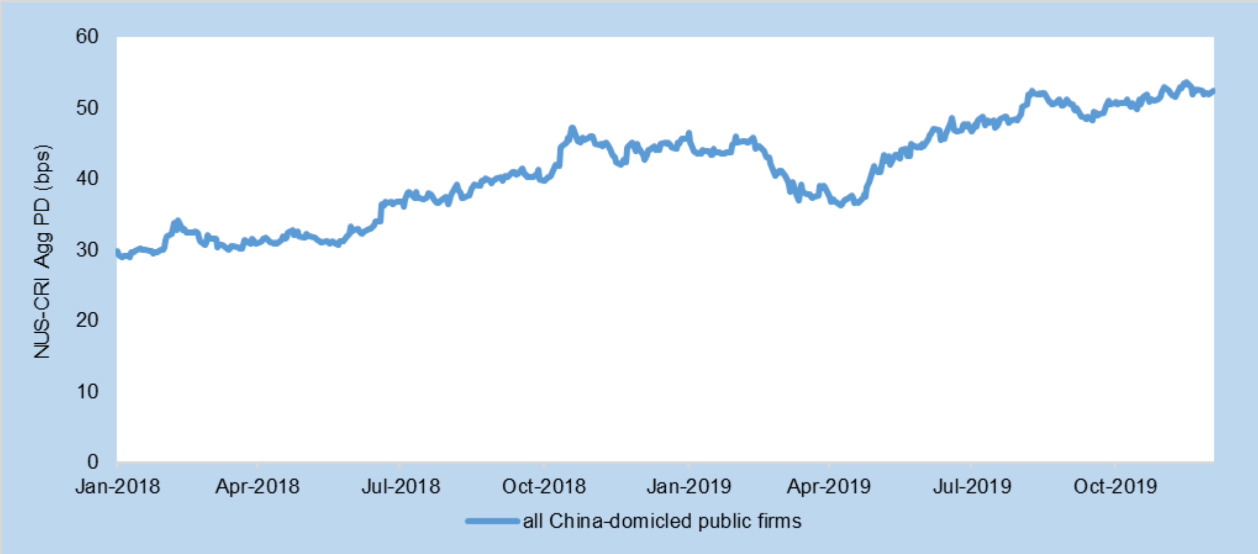

Figure 2: NUS-CRI Aggregate 1-year PD for China-domiciled publicly listed firms. *Source: NUS-CRI*

From an industry-level perspective, industries with the highest PD change from Jan 2018 to Nov 2019 are those hit by severe overcapacity - such as basic material and industrial sectors, and those cyclical industries like real estate and consumer cyclical industry which includes the automotive, housing, entertainment, and retail sectors. Those cyclical companies are highly correlated with the business cycle and economic conditions and thus credit profile for those firms has been getting worse during the economic downturn. The PD change by industry roughly coincides with the defaulted bonds industry distribution during the same period. Since 2018, more than 80% of the defaulted bonds are from basic materials, consumer cyclical and industrial sectors, which is in line with the industries' large PD increase in the period.

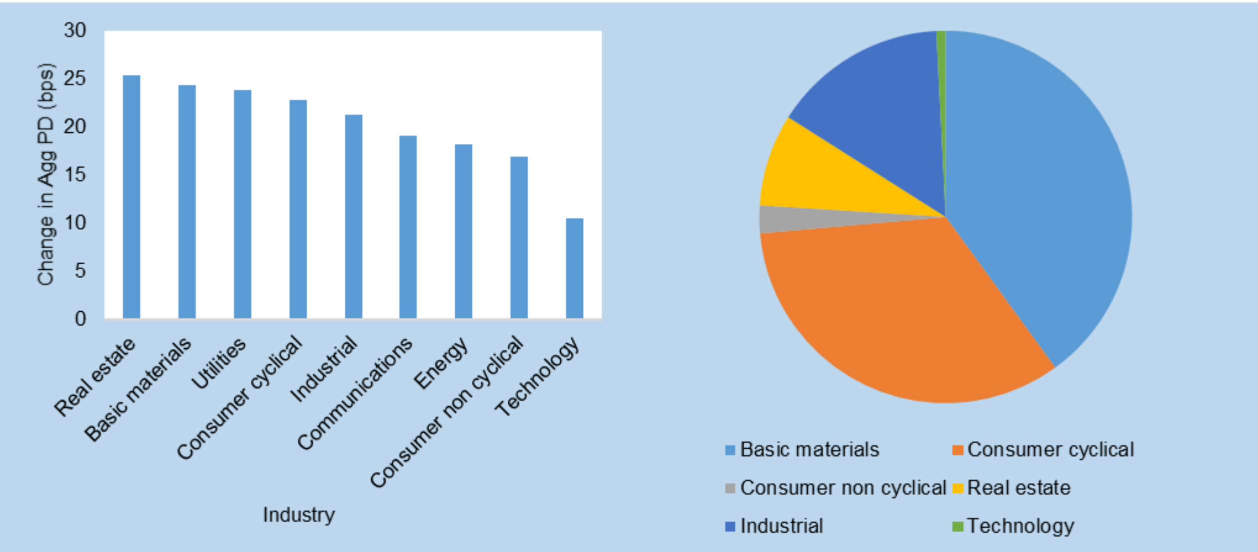

Figure 3a&3b: NUS-CRI Agg PD change by industry from Jan 2018 to Nov 2019 (LHS); China's number of defaulted bonds industry distribution from Jan 2018 to Nov 2019. *Source: NUS-CRI, Wind*

The heightened credit risk is also shown in the change of the estimated distribution of one-year default rate, which is estimated from the individual corporate PDs. Figure 4 shows that both median and mode of one-year default rates have been moving rightward since Jan 2018. When 2018 just started, the median one-year default rate for publicly listed Chinese firms was around 49bps to 52bps, it rose to approximately 70bps to 75bps in the end of 2018 and increased even more to the interval of 88 bps to 93 bps in Nov 2019. In addition, the mode of one-year default rate increased from 49 bps in Jan 2018 to around 89 bps in Nov 2019. In other words, the NUS-CRI PD model predicts around 40 out of 4414 China-domiciled companies to default over one year starting from Nov 2019.

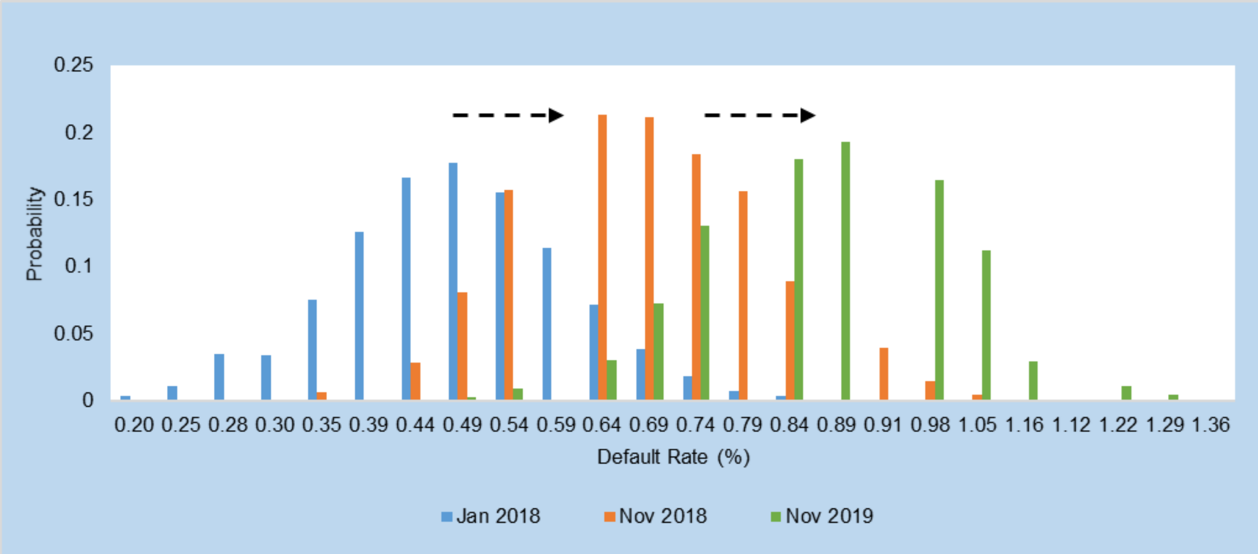

Figure 4: Estimated distribution of one-year default rates of China-domiciled corporates in Jan 2018, Nov 2018 and Nov 2019. *Source: NUS-CRI*

Looking into the future, PBOC's governor Yi Gang expects that the current market downturn will likely stay for a long time and PBOC will keep a cautious stance while refraining from large-scale easing steps. With the current slowing economic expansion and the expected not-so-loose market conditions, credit profile for Chinese firms can be worse in the future.

Credit News

Investors grid for year-end turmoil in cash markets

Dec 8. As the end of 2019 approaches, investors and regulators are preparing for new disruptions to short-term money markets in the United States. The Federal Reserve has so far committed about USD 350bn to calm the overnight repo markets – where banks and other firms borrow cash for short periods of time in exchange for collateral (such as treasuries). These efforts include injecting cash into money markets and open market purchases, a move similar to quantitative easing of the post-global financial crisis. Investors are making their own preparations – hoarding cash to hedge against a sudden rate hike at the end of the year. The overnight borrowing repo rate has spiked at the end of recent quarters and at year-end 2018, where rates climbed as high as 6%. (WSJ)

Brazil's booming credit markets fan hopes of 'revolution'

Dec 6. The listing of Brazilian financial services firm XP Investimentos in Nasdaq highlights the transition to a new world of lower interest rates. Previously, Brazilian interest rates were some of the highest among the large emerging markets for many years due to persistently high inflation expectations. Now with both inflation and inflation expectation stabilized, the Brazilian central bank is expected to cut its policy rate further. The lower interest rate opens up the corporate bond market that has been starved of credit for decades. However, the pace of market growth has raised concerns that the debt of first-time issuers is being snapped up by individuals who may not understand what they are buying, while others say such concerns are a normal part of the early stage of Brazil's transition. (FT)

Muni-bond ratings are all over the place

Dec 6. Municipal bonds are popular among individual investors for their safety and tax-advantaged status. Investors have poured a record amount of cash into municipal bonds this year as they seek out steady income and adapt to new tax rules. However, bond-ratings firms are struggling to judge the creditworthiness of cities and local governments with deep financial problems. Regulatory reforms that were supposed to improve the quality of ratings and reduce conflicts of interest after the financial crisis haven't had the intended effects. There have been widely disparate ratings, errors in analysis and a fight for market share that may have produced optimistic outlooks in the municipal market. (WSJ)

This USD 1.2tn China bond market is studded with 'fakes'

Dec 5. Local Government Financing Vehicles (LGFVs) are off-balance-sheet holding companies created by Chinese municipalities, intended to supplement the stimulus Beijing launched to rescue China's economy after the 2008 global crisis. However, LGFVs have been selling debt to fund their infrastructure projects in the past 10 years, amassing a huge pile of debt amounting to USD 4.7tn (in which USD 1.2tn are bonds). Since these firms are not part of the municipalities' budgets, LGFV bonds typically offer higher coupons, especially in a world of negative-yielding debt. The issue arises as many LGFVs are no longer adhering to their initial construction mandates, causing investors to call them 'fakes'. LGFVs have been pushing into new businesses to generate cash, but are struggling to remain profitable. Investors are instead looking for government support to buy these bonds, generating a potential bubble for LGFV bonds. (Bloomberg)

The bond market might be totally wrong about recession

Dec 3. In the current global economic landscape, where stocks are acting like bonds due to dividend yields, and bonds are acting like stocks due to capital appreciation, the bond market may give false precognition about a recession in 2020 and beyond. Australian bank Macquarie is forecasting a 1.3% yield on the US 10-year treasury at some point next year (current yield at 1.81%). However, in spite of the low yield, the vast majority of investments in investment-grade debt is in US treasuries, keeping the dollar strong. Over the next 6 to 12 months, the market is pricing in just a 10% chance of one more rate cut by the Fed. Whether there will be a recession in 2020 is to be seen where we can deduce if the credit market acted as a good indicator. (Forbes)

Twitter plans first foray into junk bond market (FT)

India readies first corporate bond ETF to fund state-run firms (Bloomberg)

UniCredit boss warns against push to incentivize 'green' lending (FT)

Regulatory updates

Wave goodbye to Libor. Welcome its successor, SOFR

Dec 6. The end to global benchmark Libor is near – where more than USD 370tn worth of existing financial products which are pegged to Libor is in search of a viable substitute. Significant progress has been made in moving toward an alternative called the Secured Overnight Financing Rate (SOFR), which is based on an average daily volume of more than USD 1tn of actual transactions in the US Treasury repo market. Unlike Libor, which has become increasingly based on estimates, SOFR accurately captures actual market pricing based on demand and supply of repo market prices, which led to the Alternative Reference Rates Committee to choose the SOFR as its recommended alternative. In November, the Federal Reserve Bank of New York outlined plans to produce SOFR averages along with a SOFR index. By publishing these averages on its website, the New York Fed will provide consistently calculated SOFR averages across various terms and an index to facilitate the calculation of averages over custom periods. (Bloomberg)

Bank Indonesia signals cautious approach to further easing

Dec 6. Indonesia's central bank has sounded a more cautious tone on interest rates, signaling that the 175bps of tightening seen last year may not be fully unwound in the current easing cycle. Indonesia's economy has lost momentum in every quarter this year but Bank Indonesia is confident that the economy will pick up in 2020 as this year's cut will start to make an impact. Furthermore, while it will keep policy accommodative to support growth, it may also use other tools besides rate cuts. For instance, the central bank held its benchmark rate steady last month but lowered the proportion of funds that banks must keep in reserve to pump cash into the economy. (Bloomberg)

Green bonds set for shake up as EU agrees rules for sustainable financial products (Reuters)

India's central bank unexpectedly keeps interest rates unchanged (CNBC)

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