China Insights

May 2021

China bonds – market forces awaken

Summary

- The Chinese government's increasing tolerance toward state owned enterprise (SOE) defaults have contributed to recent rising default rates in the onshore and offshore bond markets
- In 2018, onshore bond defaults concentrated in industries with overcapacity – namely energy, utilities, industrials, and materials; whereas last year 40 per cent of defaults by outstanding amount were in technology
- Credit differentiation is deepening in the SOE space as investors come to realise that the implicit government guarantee behind state owned enterprises is weakening

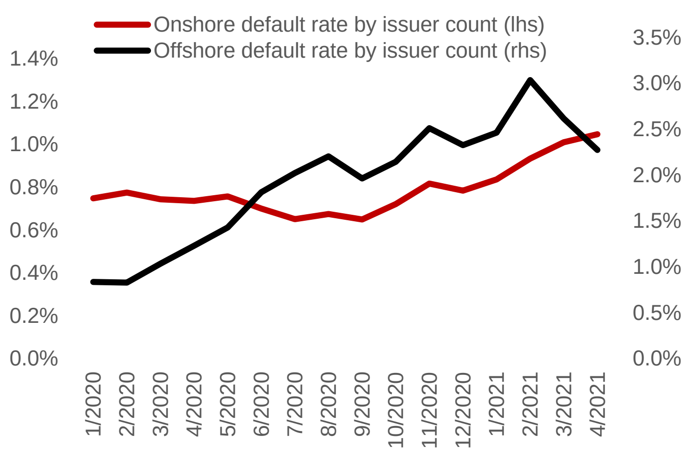
Rising default rates

Default rates have risen in both the onshore and offshore markets (see Figure 1), partly due to tighter monetary and liquidity conditions, especially in the property sector; and partly due to the government's increasing tolerance toward SOEs defaulting on their debt obligations.

In fact, Beijing has for quite some time voiced its intention to allow market forces to play a bigger role in the mechanics of the country's corporate bond market, realising that if investors were to keep assuming the state would "come to the rescue" of any financially strained state owned company, the resulting moral hazard would keep the pricing of bonds inefficient and distorted.

The pandemic might have put the government's plan on hold for a while, but as the outbreak was brought under control and the economy recovered, a series of defaults by SOEs materialised in the second half of 2020 (Figure 2).

Figure 1. Onshore and offshore default rates by issuer count



Source: Bloomberg, as of 30 April 2021
Investment involves risks. Past performance is not indicative of future performance.
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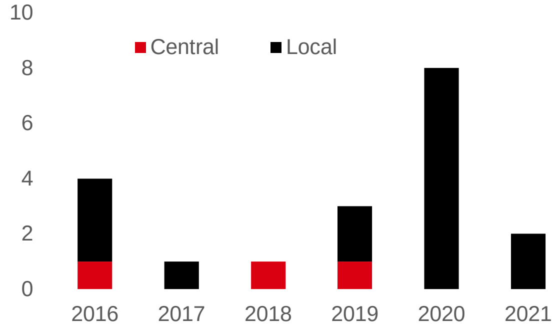
HSBC Asset Management

Figure 2. State owned defaults in the onshore market (issuer count)



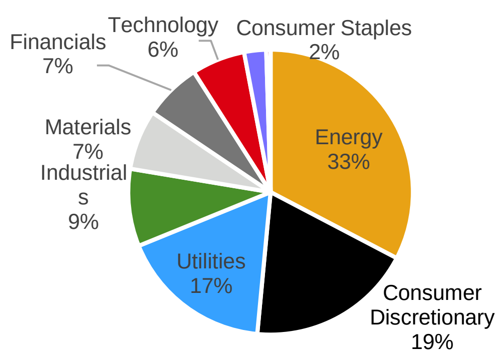
Source: HSBC Asset Management, Bloomberg, as of 30 April 2021

The sector breakdown of onshore defaults reveals that there has been a change in its composition from 2018 to 2020 (see Figure 3). Three years ago, many companies that succumbed to financial stress were those in industries affected by overcapacity – namely energy, utilities, industrials, and materials.

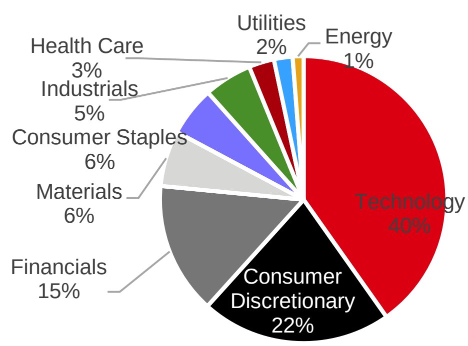
The situation changed last year, during which 40 per cent of defaults by outstanding amount were in technology, although about half of the sector's defaults could be attributed to one subsidiary of a top Chinese university. On the other hand, three quarters of offshore dollar bond defaults in 2018 were also in the energy sector; whereas in 2020, close to 70 per cent of such defaults were in financials and technology.

Figure 3. Sector breakdown of onshore defaults by outstanding amount in 2018 vs 2020

Defaults in 2018: $15 billion outstanding



Defaults in 2020: $17 billion outstanding



Source: HSBC Asset Management, Bloomberg, as of 30 April 2021

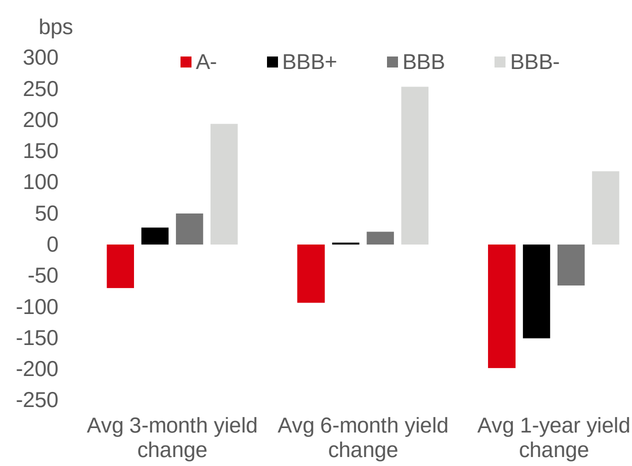
Credit differentiation

The record level of SOE defaults in 2020 has prompted investors to reevaluate their assumption of an implicit government guarantee behind most, if not all, SOEs. Unless of national strategic interest, or involving a potential systemic risk that threatens the financial system, such a guarantee should no longer be seen as a given when pricing SOE bonds.

Investors have adjusted their expectations accordingly. As a result, more credit differentiation is occurring in the SOE space. Looking to the offshore market, a widening of spreads between higher and lower internationally rated bonds is observed (see Figure 4).

A similar analysis for onshore bonds is more complicated due to the lack of international ratings, but anecdotal experience suggests similar repricing of credit risk in play. In essence, this is a welcome development in the long run as bond prices will be more driven by market factors rather than speculations of government support.

Figure 4. Yield movements of offshore local SOE bonds by Fitch rating



Source: HSBC Asset Management, Bloomberg, as of 15 May 2021

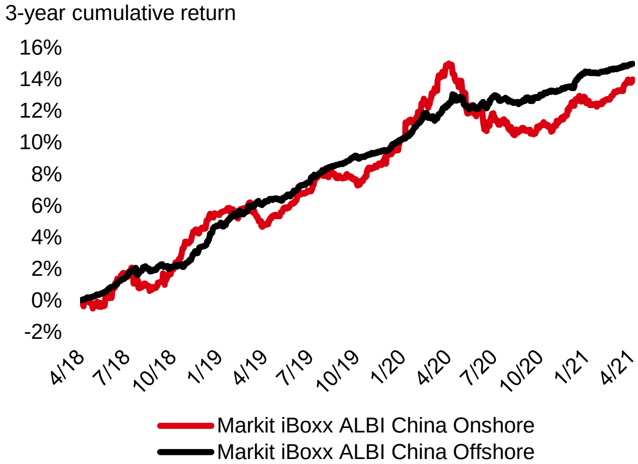
In the following pages we will take a deeper look at how recent events and policy measures are impacting Chinese fixed income and equity markets:

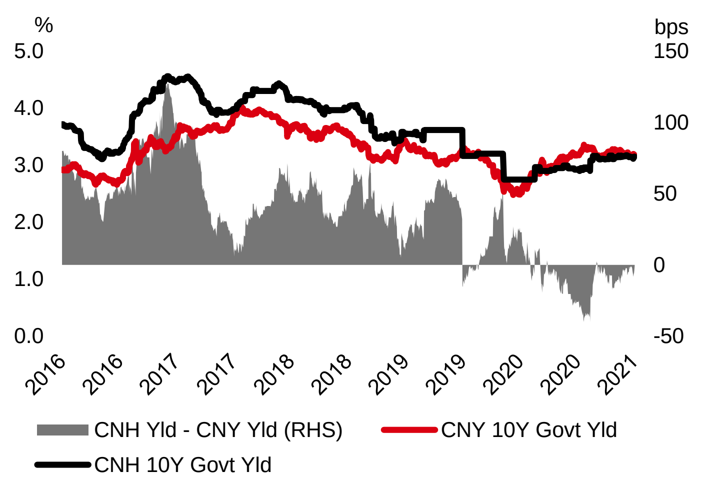
Fixed income

It is reported that the current Bond Connect scheme will be expanded to include southbound trading in July 2021, meaning that onshore investors will gain access to offshore bonds in Hong Kong.

- The Chinese Government Bond five-year and ten-year yields both fell by four basis points in April. Reflation trades have driven a sharp rise in long-end US treasury yields in the first quarter of 2021, triggering a sell-off in government debt globally. Chinese and Japanese government bonds experienced a milder impact. In fact, Chinese ten year government yields have tightened slightly year to date.
- The iBoxx ALBI China Onshore and Offshore indices gained two per cent in dollars in April, largely due to renminbi appreciation against the dollar during the month. For comparison, the Bloomberg Barclays Global Aggregate, a gauge of global investment-grade debt from twenty-four local currency markets, rose one per cent.
- It is reported that the current Bond Connect scheme will be expanded to include southbound trading in July 2021, meaning that onshore investors will gain access to offshore bonds in Hong Kong. Depending on the eventual scope and demand, this might lead to tightening pressure for offshore bonds.
- In terms of fund flows, the onshore bond market recorded $1.4 billion net foreign outflows in March, bringing the year-to-date inflow total down to $46 billion, still 30 per cent of the 2020 total. Given a favourable renminbi outlook, a persistent yield spread over developed markets credit, and the recent confirmation by FTSE Russell to include Chinese government bonds into its World Government Bond Index, we anticipate continuing strong inflows throughout the year
- The spread between the Chinese and US ten-year government bond yield has widened slightly by eight basis points, to 153 basis points. The spread has been relatively stable since the week of 22 March, with the US ten-year yield hovering at around 1.6 per cent. The dollar index, which is measured against a basket of currencies, dropped from 93 to 91 in April. In 2021, we hold a positive outlook on Chinese fixed income on the back of relatively strong foreign inflows and a continuing economic recovery.

Chinese bonds remain relatively steady amidst economic recovery





Source: Bloomberg, Markit data as of 30 April 2021. Total return in local currency terms.
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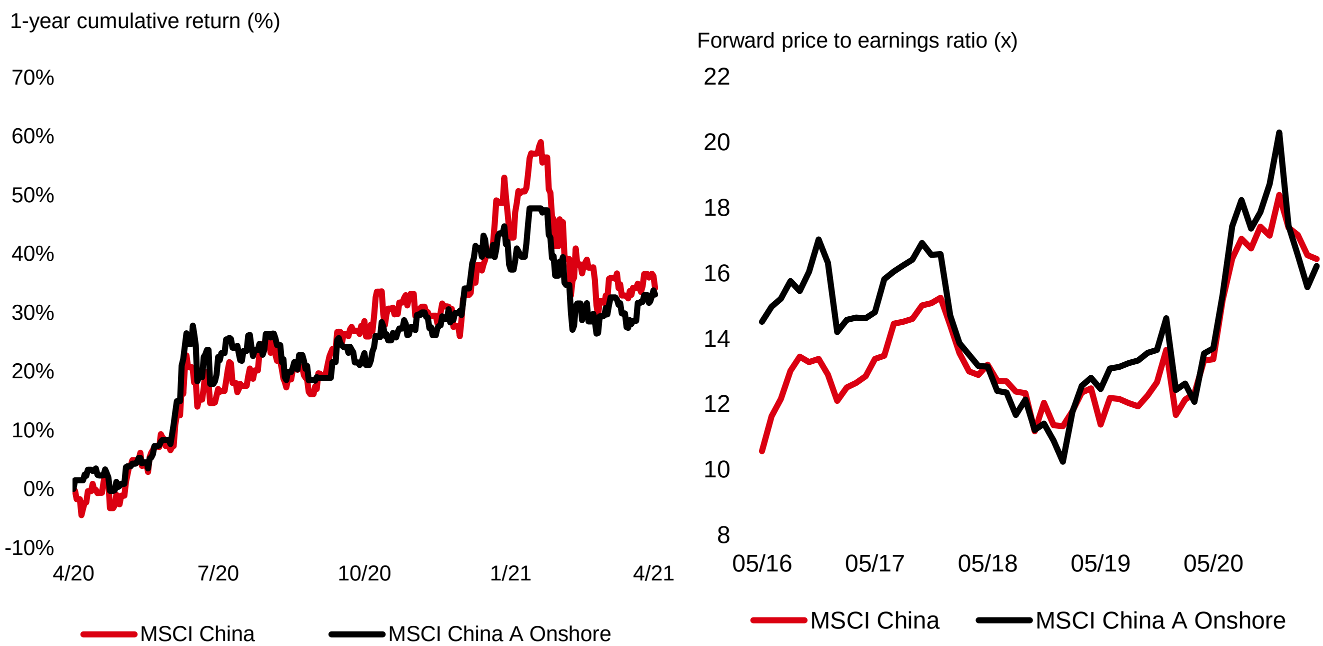
Equity market

- MSCI China A Onshore and MSCI China – the onshore and offshore gauges – gained four per cent and 1.4 per cent respectively in April in dollar terms, bucking the downward trend in the previous two months. Locally the CSI 300 Index of the country's largest companies advanced 2.8 per cent in dollar terms, while its offshore counterpart, the Hang Seng Index, was up 1.4 per cent.
- In terms of sector performance within MSCI China, healthcare went up 11 per cent, contributing the most to index performance. A second wave of Covid-19 outbreak in India increased demand for medical supplies. Materials also outperformed, at six per cent, on the back of renewed pricing strength. On the other hand, financials and real estate, having gone down by three per cent and five per cent respectively, were the biggest detractors.
- The rebound in April was mainly backed by solid earnings results and less-stretched multiples. The valuation level of some growth stocks that have met first quarter earnings expectations was back to the February peak level.
- The southbound channel, which allows mainland investors to buy Hong Kong-listed companies – saw $6 billion inflows in April, mainly into a few tech giants. Conversely, northbound trade amounted to $8 billion of inflows.
- In terms of valuations, the 12-month forward price-to-earnings of MSCI China and CSI 300 are now trading at 15 times and 14 times, respectively, with a 2021 consensus earnings growth of 28 per cent for the former and 21 per cent for the latter.

Chinese stocks continue to climb, supported by an ongoing recovery



Source: Bloomberg, HSBC Global Asset Management, as of 30 April 2021. Total return in local currency terms.

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Sector*	Outlook	Comment
Consumer Discretionary	-	We prefer names that benefit from tourism recovery given good progress on global vaccination. Strong domestic tourism recovery was seen during the Qingming Festival and Labor Day. We are cautious about the downside risk in short term earnings of e-commerce platforms, due to the ramping up of investment on community group buying.
Consumer Staples	-	Valuation of most names has become stretched. We prefer selective Chinese liquor names that could provide long term growth, as their margin expansion capabilities remain large, and that possess higher pricing power and ecommerce channels.
Energy	+	Vaccination progress has increased market expectation of global economy activity normalization. Energy stocks will benefit from cyclical rotation.
Financials	-	The rate has seen its bottom and the worst time for the sector has passed. Cyclical rebound and rotation would benefit the sector most, due to a relatively low valuation and attractive yield. We have reduced our underweight to banks and insurance companies at low valuation, given a value factor pick-up.
Healthcare	-	The valuations of some names have become stretched. We favour service providers and medical device manufacturers with high growth visibility and solid business models, which are less affected by the national reimbursement drug list policy. Companies with strong R&D and clinical development capabilities on innovative drugs will also outperform.
Industrials	-	Industry leaders with accelerated capacity expansion can gain more global market share. We prefer beneficiaries in the electric vehicles production chain and machinery manufacturers with technological advancement.
Information Technology	+	We like names that can benefit from continuous tech upgrade. The trend of technology localisation will sustain for the longer term. We also prefer semiconductor names as demand for hardware tech is still strong and inventory remains low.
Materials	O	We prefer cement and copper mining companies within the sector as the recovery trajectory is on track and increasing electric vehicle penetration will require more copper for batteries and charging stations.
Real Estate	-	The potential new "three red lines and four categories" policy may hinder long term growth for developers. Policy tightening in the property market is likely to continue, and there is no sign of loosening in the near terms.
Communication Services	O	We selectively prefer gaming and social platform companies as their market share has increased in the global market and they are less affected by anti-monopoly investigations. We are underweight telecom names due to the lack of catalysts.
Utilities	-	Increasing supplies from alternative energy sources such as wind, solar and nuclear continue to drive down the sector's returns. Demand remains lacklustre due to slower economic growth.

Source: Bloomberg, HSBC Global Asset Management, as of May 2021.
*NOTE - Sector views of HSBC Global Asset Management's offshore Chinese equity team; "+" = positive, "–" = negative, "O" = neutral
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Data watch

Indicator	Date	Actual	Consensus	Prior	Analysis
Industrial production (IP) (yoy)	Apr	9.80%	10.0%	14.1%	April activity data showed that the economic recovery remained on track, although the growth momentum eased following a strong March rebound. IP growth moderation partly reflected the impact of intensified de-carbonisation and partly due to higher raw materials/input costs exerting some pressure on profit margins. Export-oriented manufacturing sectors, however, maintained solid activity momentum. We expect a strong 8 to 9 per cent growth rebound in 2021, led by consumption, manufacturing capex and services, on the back of continued export strength.
Fixed Asset Investment (FAI) (ytd, yoy)	Apr	19.9%	20.0%	25.6%	Softer infrastructure investment was consistent with a slow start in local government special bond issuance, though a potentially accelerating pace of issuance in the second and third quarters could strengthen momentum. Manufacturing capex remained robust, amid strong industrial profit growth and brighter demand outlook. Meanwhile, real estate investment and property sales were resilient despite tightening measures in the sector.
Retail Sales (yoy)	Apr	17.7%	25.0%	34.2%	The slowdown partly reflected a reversion from March's strong gain as well as pent-up demand fading following the relaxation of January-February social distancing and travel restrictions. Recent data show ongoing gradual normalisation of tourism and domestic air traffic. We expect continuing improvements in the economy to support consumption.
Exports (USD) (yoy)	Apr	32.3%	24.1%	30.6%	The export strength points to robust external demand and was boosted especially by demand from select emerging market economies while shipments to developed markets moderated from high levels. Imports also picked up further, on the back of a favourable base effect and boosted by the ongoing domestic demand recovery, higher commodity prices and the yuan strength.
Imports (USD) (yoy)	Apr	43.1%	44.0%	38.1%	
Trade Balance (USD)	Apr	$42.9bn	$27.7bn	$13.8bn	
CPI Inflation (yoy)	Apr	0.9%	1.0%	0.4%	The jump in PPI inflation was boosted by a low base and the continued rise in commodity and raw material prices, as a result of recovering global demand and a wide range of supply constraints, including China's emission-control policies. While some of the PPI reflation may transmit to downstream sectors in the form of firmer pricing power and perhaps beyond into core consumer goods prices, the magnitude will likely be limited given the competitive landscape in many consumer markets, which may weigh on the profit margins of some downstream companies. We do not expect PPI reflation to translate into above-target CPI or rate hike.
PPI Inflation (yoy)	Apr	6.8%	6.5%	4.4%	
Aggregate financing (AF) (RMB)	Apr	1850bn	2290bn	3340bn	The slowdown in credit growth was driven by further weakness in off-balance sheet items and a decline in short-term bank loans to households and corporates, likely due in part to increased regulatory scrutiny on the illegal use of business and consumer loans for property financing, and in part to reduced corporate borrowing for working capital thanks to improved earnings. Resilient medium-to-long-term loans likely reflected still solid housing demand despite tighter policies, as well as continued corporate capex recovery. Bond issuance is expected to pick up in the second and third quarters. We expect moderate credit deceleration in 2021.
New yuan loans (RMB)	Apr	1470bn	1600bn	2730bn	

Indicates improved data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates worsened data on month-on-month/quarter-on-quarter/year-on-year basis

Indicates no change in data on month-on-month/quarter-on-quarter/year-on-year basis

Source: Bloomberg, Wind, HSBC Asset Management, as of May 2021

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