



Agents of creative destruction

Keeping Chinese credit honest & healthy

With defaults doubling in 2018, Chinese corporate credit has become a headline topic for EM debt investors. Numbers that might seem alarming at first glance run the risk of overshadowing what is otherwise a healthy and appropriate market response to the Chinese government's conscious policy tilt towards economic deleveraging.

PUBLISHED
January 2019

READ TIME
5 mins

AUTHOR
Alan Siow
Portfolio Manager, Emerging Market Debt



Chinese corporate credit: The background

Low non-performing loan (NPL) ratios among Chinese corporates, alongside the relative absence of defaults, have historically been used as reasons to criticise the Chinese system for being artificial, not operated according to market principles, and based on an unhealthy presumption that the government implicitly guaranteed all defaults. The general conclusion was that Chinese corporate credit was not a 'true' market.

Many commentators (including the International Monetary Fund, Bank for International Settlements and the World Bank) have gently chided the Chinese administration on the need for reforms, based on the view that a credit market without defaults was unhealthy, especially against the context of an economy where rising leverage was becoming an increasing source of global concern.

The Chinese administration seemingly took this to heart, and hence the motivation and steadfast resolve for deleveraging. The consequence: rising default rates.

However, some of the same voices that criticised the lack of defaults previously are now raising alarm bells at their appearance – this crowd is hard to please!

Should investors be concerned?

Not necessarily.

While defaults have been rising in both overall number and in terms of the amount of debt in question, investors should not be overly concerned; to the extent that this is an expected and rational consequence of Chinese deleveraging policy.

Recent developments

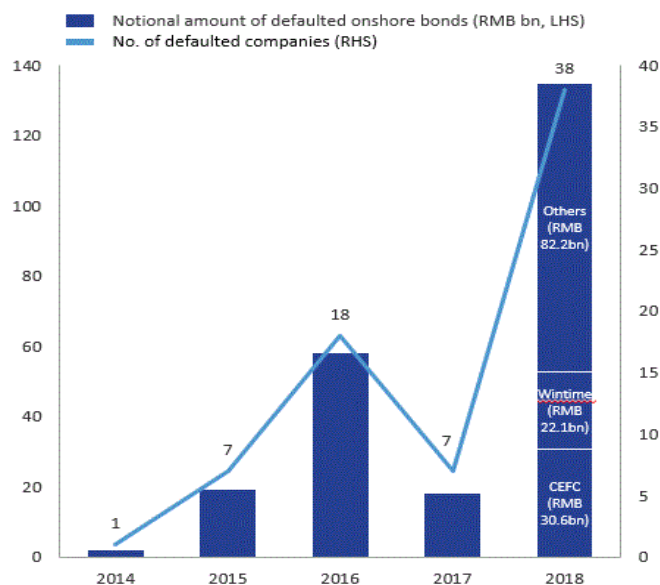
While the number of defaults more than doubled in 2018 to 38 (from 18 in 2016), and while the notional amount has also more than doubled from approximately RMB50 billion in 2016 to RMB135 billion in 2018, this still represents just 0.7% of the entire Chinese corporate bond universe – it’s hardly a calamity.

Rather than being distracted by headlines centred on a deterioration of credit quality, rising defaults are likely symptomatic of tightening liquidity in the economy overall, which should be expected from a deleveraging campaign.

However, given the idiosyncrasies of the Chinese system (which favours large firms and firms with links to the state), the tightening of liquidity disproportionately affected the private sector, with the SME sector the hardest hit.

The Chinese government appears to have realised this unintended consequence and is actively tweaking its policy. It is holding fast to the deleveraging mantra, but also working to ensure that smaller, private firms are not unfairly penalised.

CHINA ONSHORE BOND DEFAULTS SINCE 2014



Source: Wind, Bloomberg, company announcements, Goldman Sachs Global Investment Research. As at January 2019.

Notes: 1 we exclude defaults from privately placed Corporate Bonds (i.e. those regulated by CSRC) issued prior to 2015, as they related to small sized unlisted companies with very limited information disclosure. 2 even though most Chinese onshore bonds do not have cross default clauses, we assume that if a company defaults on one bond, they are in default on all their bonds.

What should investors expect in 2019?

- While we should keep a close eye on how events develop, we believe Chinese defaults would have to rise meaningfully from current levels before investors need to be concerned.
- In addition to the absolute number and amount of defaults rising, the degree of investor concern should be commensurate to the underlying cause:
 - A default wave that is policy-led, and where defaults are therefore an intended consequence and represent a healthy development for credit markets overall, need not be feared – after all, defaults are the agents of creative destruction that are needed to keep the credit markets honest and healthy.
 - Conversely, a rising wave of defaults that is led by slowing growth, falling margins and profits is one that should rightfully command the attention of investors.

The bottom line for credit buyers

Despite the government's best intentions, the development of Chinese credit markets will not be smooth.

Investors (and therefore asset prices) remain susceptible to unfriendly headlines because this is still a market that is maturing and learning to develop skills in credit analysis and selection.

As domestic participants in the Chinese debt markets learn to discern good credits from bad ones (instead of relying on old rules of thumb like size, or proximity and relationships to regional and state governments as ways to ration credit), we can expect dispersion and volatility to rise.

As already seen, this will give rise to dislocations and volatile price action that should create opportunities for performance in both the hard and local currency universe.

We believe that an unconstrained, fully active strategy that can evaluate and invest in the best ideas across both hard currency and local currency markets, in both the corporate and sovereign space, is best placed to exploit these potential opportunities.

DISCLAIMER

Issued in the United Kingdom (UK) by BlueBay Asset Management LLP (BlueBay), which is authorised and regulated by the UK Financial Conduct Authority (FCA). BlueBay is also registered with the US Securities and Exchange Commission (SEC) and is a member of the National Futures Association (NFA) as authorised by the US Commodity Futures Trading Commission (CFTC). In the United States it may be issued by BlueBay Asset Management USA LLC which is registered with the SEC and NFA. In Japan by BlueBay Asset Management International Limited which is registered with the Kanto Local Finance Bureau of Ministry of Finance, Japan. In Switzerland by BlueBay Asset Management AG where the Representative and Paying Agent is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, 8002 Zurich, Switzerland. In Germany BlueBay is operating under a branch passport pursuant to the Alternative Investment Fund Managers Directive (Directive 2011/61/EU). The registrations and memberships noted should not be interpreted as an endorsement or approval of any of the BlueBay entities identified by the respective licensing or registering authorities. Information herein is believed to be reliable but BlueBay does not warrant its completeness or accuracy. Opinions and estimates constitute our judgment and are subject to change without notice. No part of this document may be reproduced in any manner without the prior written permission of BlueBay. © Registered trademark of Royal Bank of Canada. RBC Global Asset Management is a trademark of Royal Bank of Canada. Copyright 2019 © BlueBay Asset Management LLP, registered office 77 Grosvenor Street, London W1K 3JR, England, partnership registered in England and Wales number OC370085. All rights reserved.