China Credit Strategy

Multiple pressure for credit yields – Q216 credit market outlook

Credit Strategy

China

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Macro economy, bond supply and demand

China's GDP growth in Q1 2016 stabilized at 6.7% YoY and other data also show that a pick-up might be on the way. UBS economists believe that the effect of policy support and improving property activity will carry into Q3, and have upgraded their 2016 and 2017 GDP growth forecasts to 6.6% and 6.3%, respectively. For the benchmark lending rates, UBS economists believe there will be limited room for further looser monetary policy, and there will be no further rate cut this year. On the liquidity side, we believe that the People's Bank of China's (PBC) operations remained prudent in Q1. We believe the necessity for further RRR cuts has decreased in the short term, but the PBC will still keep it as a reserve facility to offset potential capital outflow. Investors' expectations for further rate cuts in PBC's short-term facilities remain low. We believe repo rates could remain stable with flexible liquidity management facilities by the PBC. Supply of both rates and credit bonds were strong in Q1, while the bid-to-cover ratios for China government bonds (CGB) auctions and repo leverage ratios were weakening.

Credit market

The number of credit events in 2016 increased notably from 2015, and has accelerated since March. We believe investors' risk preference might continue to decrease, and the demand for industrial bonds (especially the low grades) will be further negatively affected and a preference for Local Government Financing Vehicles (LGFV) bonds could continue in the short term. As for industry spreads, with weak profit expectations and limited room to loosen financing conditions further, we believe it will be hard for industrial issuers' solvency or investors' interest to recover, and industry factors will continue to push up the industry spreads for the those cyclical industries with top spreads. As for the major products, we believe the concern for potential risk for adjustment in corporate bond issuance, after the sharp increase in issuance, will be higher than those for enterprise bonds and the medium-term notes (MTN)/private placement notes (PPN). In the secondary market, yields and spreads started rising in late Q1. We believe the adjustment in yields and spreads for the low grades could be clearer in the next quarter.

Credit strategy

We believe investors were still able to get additional returns by moving down the credit curve in Q116, while the return differences over tenors were much less, especially for bonds of less than five years' tenor. For Q216, we believe the negative influence of a stabilizing economy will continue, and demand might be depressed by less expectation of a loosening monetary policy. Together with strong supply in both rates and credit, we believe these might cause benchmark yields to keep rising. On the other side, we think the potential growth rate in the long term will continue to decrease, thus there will only be limited room for yields to rise. Considering the risks in rising benchmark yields, higher volatility for credit bonds than for rates, and expanding industry spreads, we think credit may underperform rates. We suggest investors to strike a balance between the high coupon rates and rising risk for low-grade credits, and pick bonds with AA+ and AA ratings. As for tenors, we think it would be more prudent to choose short-term ones, that is, those of less than three years.

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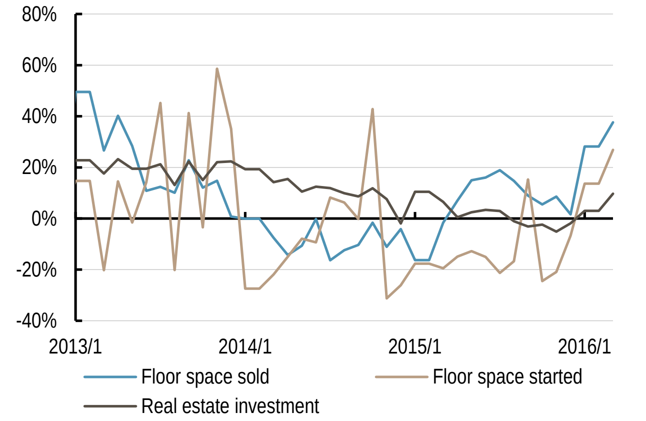
Macro economy and bond supply/demand

Macro economy and monetary policy

China's GDP growth in Q1 2016 stabilized at 6.7% YoY, and other data also show that a pick-up might be on the way. The growth rates of property and infrastructure investment are both rising on a YoY basis, with Rmb loans/credit bonds having expanded at historical high levels in Q1. The CPI has also been climbing for the past three months, and we expect inflation pressure from food to last until H2 2016. After the stabilization of the CNY exchange rate, the pressure of capital flight in March also decreased from that at the beginning of 2016, but CNY depreciation pressure might rise again once the US dollar gains momentum, given our rate-hike expectations.

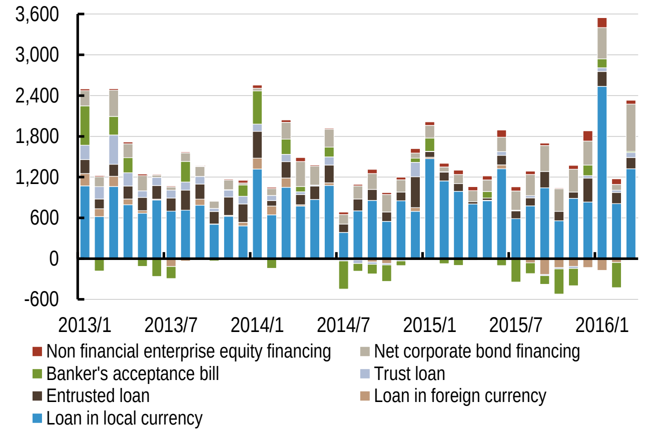
UBS economists believe the effect of policy support and improving property activity will carry into Q3, and have upgraded their 2016 and 2017 GDP growth forecasts to 6.6% and 6.3% (previously 6.2% and 5.8%), respectively. For the benchmark lending rates, UBS economists believe that there will be limited room for further loosening of the monetary policy, and that there will be no further rate cuts in 2016.

Figure 1: Surging property construction



Source: CEIC

Figure 2: New total social financing (Rmb bn)

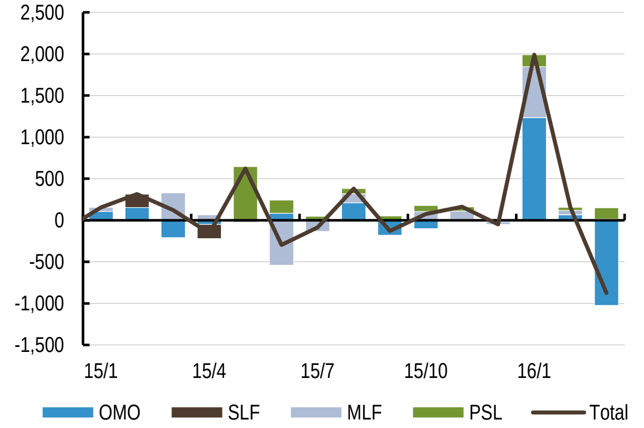


Source: CEIC

On the liquidity side, the PBC's operations remained prudent in Q1. The injection by open-market operations (OMO) in January was mostly offset in March after the Spring Festival. The quarterly net injection by OMO was only Rmb275.0bn. To provide medium and long-term liquidity, the PBC also injected Rmb665.5bn and Rmb313.6bn by medium-term lending facilities (MLF) and Pledged Supplementary Lending (PSL), respectively. Besides, the RRR cut effective on 1 March 2016 might have released cRmb700bn in liquidity. We believe the necessity for further RRR cuts has decreased in the short term, but the PBC will still keep them as a reserve facility to offset potential capital outflow. As for rate levels, repo rates in the interbank market remained stable except at the quarter end. The PBC downgraded the operating rates of MLFs on 16 March, but did not inject any liquidity on the

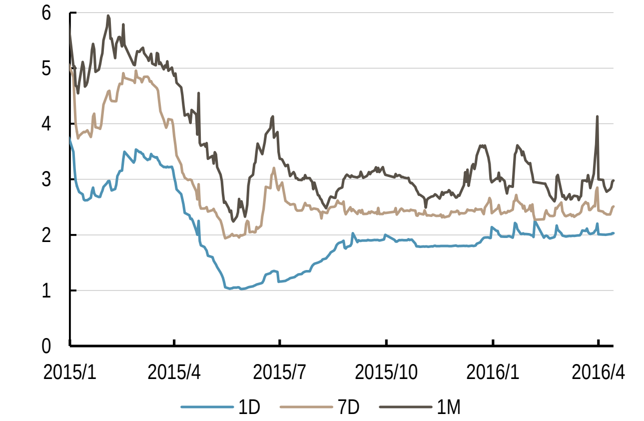
following day, and the rates were back to February levels in April. Investors' expectations for further rate cuts in PBC's short-term facilities remain low. We believe repo rates could remain stable with flexible liquidity management facilities by the PBC.

Figure 3: Prudent injection (Rmb bn)



Source: CEIC, UBSS

Figure 4: Interbank repo rates (%)



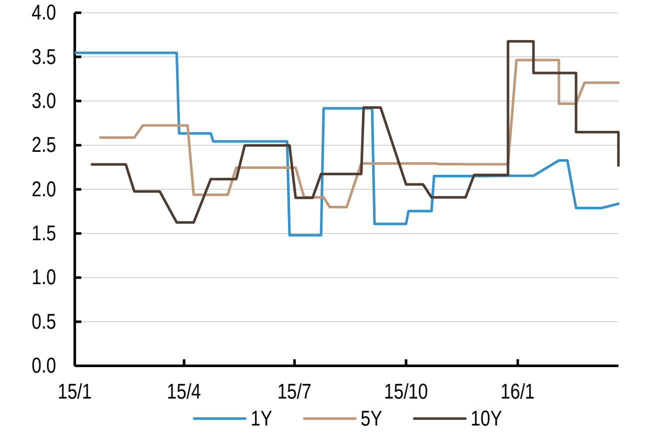
Source: CEIC

Bond supply and demand

In the rates market, the issuance of local government bonds (LGB) in Q1 was higher than those in previous years, but liquidity in the bond market remained largely unaffected. Net issuance of non-commercial papers (non-CPs) and commercial papers (CP) in the credit space were Rmb1.34trn and Rmb300bn, respectively, having increased for the fourth quarter in a row. We believe the high supply in Q1 reflected issuers' willingness to borrow early. Currently there are no signs of the primary market tightening yet; we believe the issuance in Q2 will remain at a high level with seasonal effects and strong demand from the property and infrastructure sectors. However, with rising yield trends from the end of March, the QoQ growth of supply might be affected if market sentiment continues to weaken.

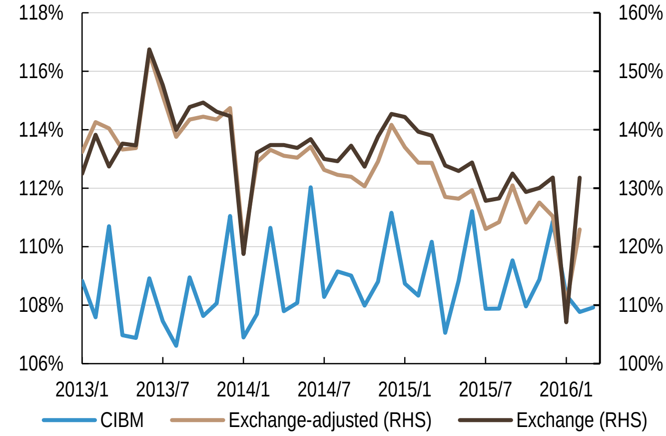
On the demand side, the bid-to-cover ratios for CGB auctions in Q1 are better than those in Q415. We believe it is mainly because of the asset allocation effect at the beginning of 2016. However, the ratios have been decreasing throughout Q1. Repo leverage ratios in the interbank market did not rebound as usual after the Spring Festival either. We believe these figures could partly reflect weakening market sentiment and a more prudent attitude towards future trends.

Figure 5: Bid-to-cover ratios for CGB auctions



Source: Wind

Figure 6: Repo leverage ratios



Source: Wind, CEIC, UBSS

Credit market

Credit events

The number of credit events in 2016 has obviously increased to more than those in 2015, and has accelerated since March. Events can still be found in 1) private companies, 2) cyclical industries like steel/mining/shipping, and 3) industries with excess capacity such as solar energy. Influences by these events are less as they are within market expectations. The local and central SOE cases of Dongbei Special Steel and China Railway Materials further reminded investors about the credit risk from the SOE sector. We believe investors' risk preference might continue to decrease, and demand for industrial bonds (especially the low grades) will be further negatively affected.

Figure 7: Summary of major credit events in 2016

Issuers	Related risk areas	Bonds	Coupon rate (%)	Maturity Date	Credit events
Shandong Shanshui Cement Group	Private company	13MTN1	5.44	2016-01-21	Default
		14MTN001	6.10	2017-02-27	Default, interest recovered
		15SCP001	5.30	2015-11-12	Default, interest recovered
		15SCP002	4.50	2016-02-12	Default, interest recovered
Yabang Investment Holding Group	Private company	15CP001	7.95	2016-02-09	Default, fully recovered
Baoding Tianwei Group Transformer Co	Solar energy industry	11MTN1	5.85	2016-02-24	Default
		13PPN001	5.80	2016-03-27	Default
Shanghai Yunfeng Group Co.	Shareholders' support	15PPN001	8.00	2017-01-22	Default
		15PPN003	7.00	2016-05-13	Default
Zibo Hongda Mining Industry Ltd Co	Private company / Mining	15CP001	8.00	2016-03-08	Default, fully recovered
China Newstar Energy Co	SME bonds	12 SME bond	10.00	2016-03-22	Partly default.
Wuhan Guoyu Logistics Industry Group	Shipping industry	15CP001	7.00	2016-08-06	Default on loans by the issuer and its subsidiaries
		15CP002	7.00	2016-10-28	
Sainty Marine Corporation Ltd.	Shipbuilding industry	12 corporate bond	6.60	2019-09-18	Guarantor compensatory
Nanjing Yurun Food Co	Private company	15CP001	6.45	2016-03-17	Default, fully recovered
Dongbei Special Steel Group Co	Local SOE / Steel	15CP001	6.50	2016-03-27	Default
		15SCP001	6.00	2016-04-03	Default
		13MTN2	5.63	2018-04-12	Default
Shanxi Huayu of Chinacoal Co	Mining	15CP001	6.30	2016-04-06	Default, fully recovered
China Railway Materials Company	Central SOE	15SCP004	4.40	2016-05-17	Suspended trading in nine outstanding bonds
Zhejiang Communications Investment Group		09MTN2	5.20	2016-08-11	Default by secondary-level subsidiaries

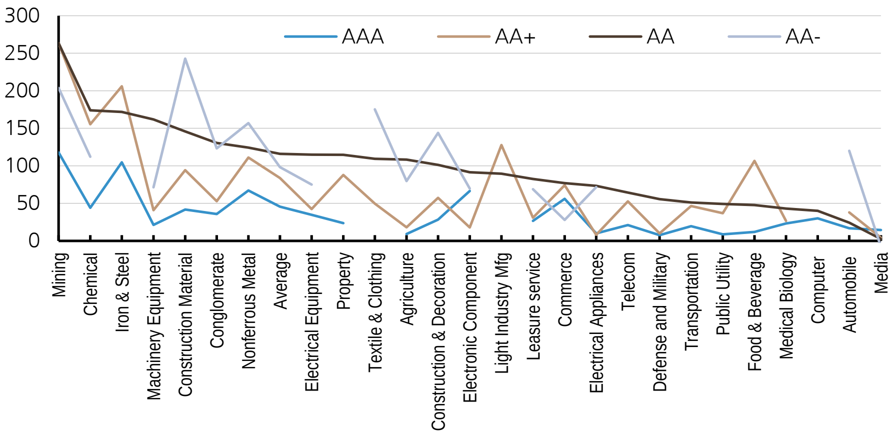
Source: Wind, UBSS

We believe the clearance of excess capacity will last for some time, and the uncertainty about the detailed plans for supply-side reform and debt-to-equity swaps might continue to affect the cyclical and capital-intensive industries negatively in the following years. Investors might continue to avoid related industries and private companies. Currently the LGFV bonds still have fewer credit events. Once substantial credit events emerged in this sector, they could have an infectious effect on all LGFV names and result in an increase in LGFV-to-industrial spreads. However, we believe that as infrastructure still plays an important role in stabilizing the economy, an open financing environment for LGFVs will remain necessary, and investors might retain their preference for LGFV bonds in the short term.

Industry spreads

For the major cyclical industries, such as mining, chemical, steel, construction materials and non-ferrous metals, industry spreads are respectively higher than others' for the four major ratings. In the past several months, industry spreads have continued to rise for steel, mining and chemical, although average industry spreads have remained stable.

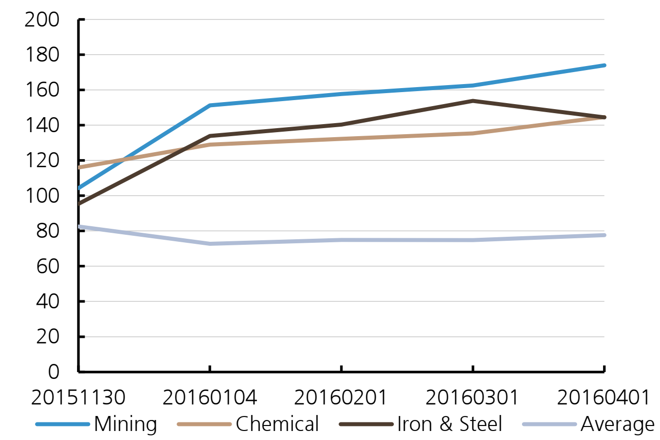
Figure 8: Industry spreads by ratings (bp)



Source: Wind, UBSS. Data as of April 1 2016

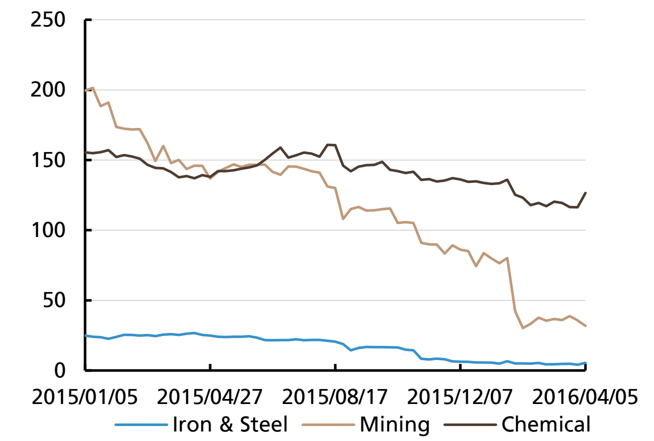
The expected 2016 profit for the three industries with highest industry spreads have been worsening over the past year. Although there have been some signs of a recovery recently, the market's profit expectations for mining are still that profits will be lower than the 2015E level, and that the profit for steel will still be close to zero. With weak profit expectations and limited room for further loosening financing conditions, we believe it will be hard for these three industries' solvency or investors' interests to recover, and industry factors will continue to push up the industry spreads for the cyclical industries with top spreads.

Figure 9: Trends of industry spreads (bp)



Source: Wind, UBS

Figure 10: Expected profit of A-share listed companies (Rmb bn)



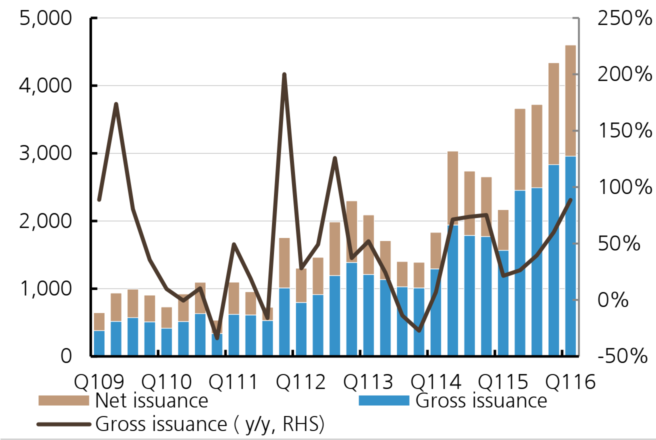
Source: Go-goal

Primary market

The gross and net issuance of credit bonds increased for the fourth quarter in a row, the longest period of increases since 2008. Corporate bonds contributed most, with gross supply of Rmb819bn. The amount of enterprise bonds was

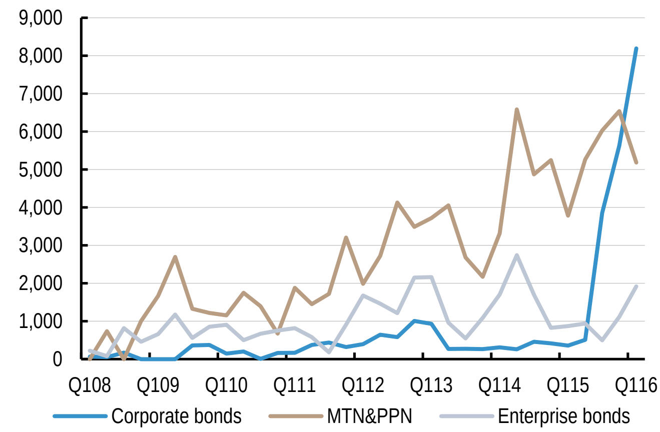
Rmb192bn, also having increased for the second quarter. The amount of MTNs and PPNs remained stable, with gross issuance of Rmb519bn.

Figure 11: Issuance of credit bonds (Rmb bn)



Source: Wind

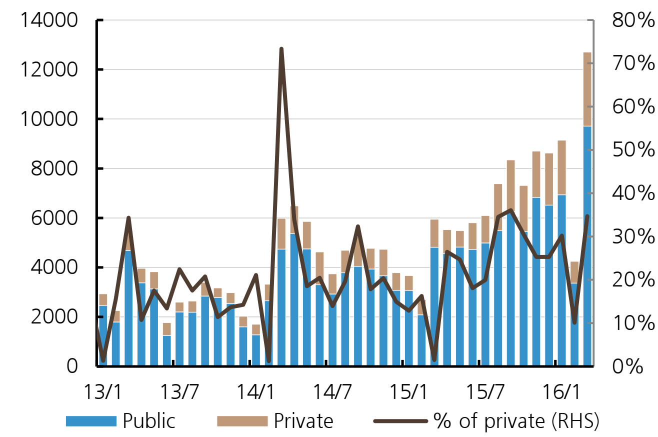
Figure 12: Gross issuance by major products (Rmb100m)



Source: Wind

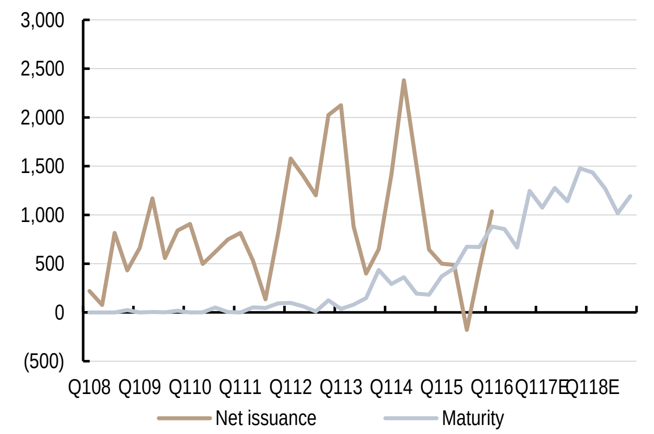
We note that the share of private placement bonds has been on a rising trend. Another new product – project revenue notes (PRN) – was successfully launched by the National Association of Financial Market Institutional Investors (NAFMII) and 13 bonds have been issued. Two more project revenue bonds approved by the National Development and Reform Commission (NDRC) were successfully issued and increased the outstanding number of this product to eight. As innovation from the regulators is still on the way, the maturity amounts for MTN/PPN and enterprise bonds are, respectively, stable and rising for the following one or two quarters, and as financing channels are still important to infrastructure projects, we believe the risk for policy tightening is low for NAFMII and NDRC. However, after the sharp increase in corporate bond issuance, we believe concern about potential risk by the China Securities Regulatory Commission (CSRC) might rise and the risk for adjustment in the corporate bond issuance will be higher than those for the enterprise bonds and MTN/PPN.

Figure 13: Increasing share of private issuance (Rmb100m)



Source: Wind

Figure 14: Net issuance and maturity of enterprise bonds (Rmb100m)

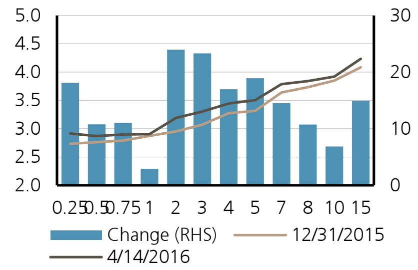


Source: Wind

Secondary market

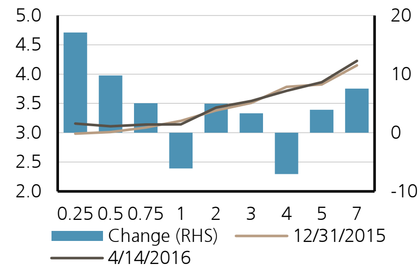
The yields for CGB were decreasing from January to early March. The current rise can be attributed mainly to tight liquidity in the end of Q1 and recovering expectations of economic growth. Compared with that at the end of 2015, the yield curve for CGB has steepened, with the short end decreasing by 7-9bps and the long end increasing by 2-11bps. The yield curve for credit bonds rated AAA moved up by 3-23bps. Less adjustment could be found with the yields for bonds rated AA-, the yields for one-to-five year tenors decreased by 4-12bps.

Figure 15: AAA yields (%, bp)



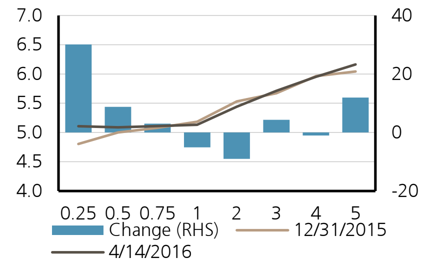
Source: Reuters

Figure 16: AA+ yields (%, bp)



Source: Reuters

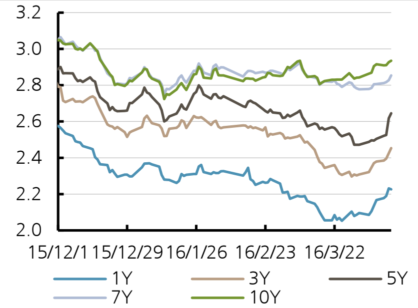
Figure 17: AA- yields (%, bp)



Source: Reuters

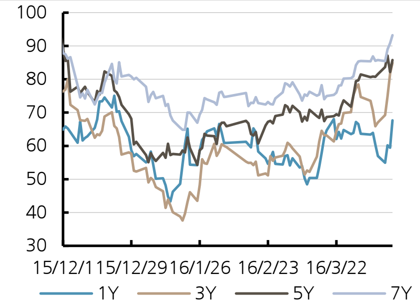
From the perspective of credit spreads, the adjustment to AAA bonds was earlier than that for the CGBs. We think it is because the yields for AAA bonds decreased more in early Q1 and adjust more quickly when yields begin to rise. We believe the adjustment in yields and spreads for the low grades could be seen in the next quarter.

Figure 18: CGB yields (%)



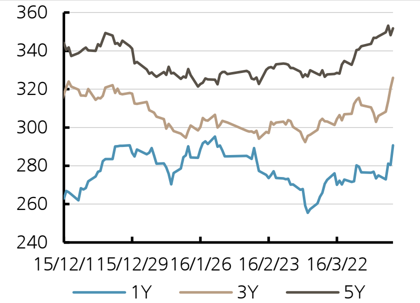
Source: Reuters

Figure 19: AAA credit spreads (bp)



Source: Reuters, UBSS

Figure 20: AA- credit spreads (bp)



Source: Reuters, UBSS

Credit strategy

As shown in Figure 21, we believe investors were still able to get additional returns by moving down the credit curve in Q116, while the return differences over tenors were much less, especially for bonds of less than five years' tenor. However, taking into consideration the rising risks for low grades (AA- and below), we believe the coupon advantage of credit bonds might be fading.

Figure 21: Holding period return in Q116 (%)

Rates		1Y	3Y	5Y	7Y	10Y
CGB		0.73	1.35	1.78	1.24	0.54
PFB (non CDB)		0.63	0.63	0.58	0.18	0.07
PFB (CDB)		0.59	0.48	0.69	0.03	-0.22
Credit		**1Y**	**3Y**	**5Y**	**7Y**	**10Y**
CP&MTN	AAA	0.77	0.80	1.01	1.13	1.30
	AA+	0.95	1.49	1.90	1.66	-
	AA	1.32	2.10	2.21	1.90	2.82
	AA-	1.46	2.09	2.27	-	-
Enterprise bonds	AAA	0.76	0.75	1.08	1.15	1.12
	AA+	1.00	1.44	1.85	1.63	1.96
	AA	1.40	2.04	2.03	2.06	2.22
	AA-	1.46	2.19	2.12	1.97	2.50

Note: Holding period is from 31 December 2015 to 31 March 31 2016. CDB stands for China Development Bank.
Source: Reuters, UBS-S estimates

For Q216, we believe the negative influence of a stabilizing economy will continue, and demand might be depressed by less expectation of a loosening monetary policy. Together with the strong supply in both rates and credit, we believe the benchmark yields might keep rising. On the other hand, we think the potential growth rate in the long term will continue to decrease, thus there will only be limited room for yields to rise. Considering the risks in rising benchmark yields, the higher volatility of credit bonds than that for rates, and expanding industry spreads, we think credit may underperform rates. We suggest investors balance between the high coupon rates and rising risk for low-grade credits, and pick bonds with AA+ and AA ratings. As for tenors, we think it would be more prudent to choose those of less than three years' tenor.

Figure 22: Expected return analysis (%)

		1	2	3	4	5	6	7
AAA	Current YTM	2.95	3.23	3.28	3.48	3.52	3.71	3.83
	Duration (Year)	1.00	1.97	2.91	3.80	4.67	5.49	6.27
	Coupon	0.74	0.81	0.82	0.87	0.88	0.93	0.96
	Roll-down	0.01	0.12	0.03	0.18	0.05	0.24	0.18
	Expected HPR	**0.75**	**0.93**	**0.85**	**1.05**	**0.93**	**1.17**	**1.14**
	Break-even	0.09	0.05	0.08	0.05	0.08	0.07	0.06
AA+	Current YTM	3.03	3.35	3.42	3.67	3.71	3.90	4.02
	Duration (Year)	1.00	1.97	2.90	3.79	4.65	5.46	6.24
	Coupon	0.76	0.84	0.85	0.92	0.93	0.97	1.01
	Roll-down	0.01	0.14	0.05	0.22	0.05	0.24	0.18
	Expected HPR	**0.77**	**0.98**	**0.90**	**1.14**	**0.97**	**1.22**	**1.19**
	Break-even	0.10	0.06	0.10	0.05	0.09	0.07	0.07
AA	Current YTM	3.14	3.46	3.54	3.85	3.97	4.28	4.43
	Duration (Year)	1.00	1.97	2.90	3.78	4.63	5.42	6.17
	Coupon	0.78	0.87	0.88	0.96	0.99	1.07	1.11
	Roll-down	0.01	0.14	0.05	0.28	0.13	0.39	0.22
	Expected HPR	**0.80**	**1.01**	**0.94**	**1.24**	**1.13**	**1.46**	**1.33**
	Break-even	0.10	0.06	0.12	0.08	0.13	0.09	0.09
AA-	Current YTM	3.82	4.17	4.27	4.60	4.87	5.26	5.45
	Duration (Year)	1.00	1.96	2.88	3.74	4.56	5.30	6.00
	Coupon	0.95	1.04	1.07	1.15	1.22	1.31	1.36
	Roll-down	0.05	0.15	0.06	0.29	0.29	0.49	0.28
	Expected HPR	**1.00**	**1.20**	**1.13**	**1.44**	**1.51**	**1.80**	**1.64**
	Break-even	0.08	0.08	0.07	0.08	0.08	0.08	0.08

Note: Data as of 14 April 2016. We assume that the yield at the end of Q216 is the same as on 14 April 2016, and use that as the coupon rate. The table shows the expected holding period of return as holding the bond for three months with no change of the yield curve.
Source: Reuters, UBS-S estimates

Valuation Method and Risk Statement

Bonds are subject to changes in both actual and perceived measures of the credit worthiness of issuers, credit rating by independent credit rating agencies, liquidity risk, market risk, interest rate risk, exchange rate risk, etc.

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Issuer Ratings						
	UBS Terminology	**Rating Category**[1]	**Time Horizon**	**Definition**	**Coverage**[2]	**IB Services**[3]
Credit Outlook	Positive	Buy	Up to 6 months	UBS' expected trend in a company's creditworthiness	3%	44%
	Stable	Hold			70%	40%
	Negative	Sell			27%	33%
	UBS Terminology	**Time Horizon**		**Definition**		
Credit Rating	AAA, AA, A (+/-)	Up to 12 months		UBS' assessment of a company's creditworthiness. Credit Ratings are only used in the evaluation of Swiss corporates.		
	BBB, BB, B (+/-)					
	CCC, CC, C (+/-)					
Security Recommendations						
	UBS Terminology	**Time Horizon**		**Definition**		
Bond Recommendation	Outperform	Up to 3 months		A corporate bond's expected relative performance versus a defined reference		
	Marketperform					
	Underperform					
	UBS Terminology	**Time Horizon**		**Definition**		
CDS Recommendation	Buy Protection	Up to 3 months		Recommendation to hedge a company's creditworthiness		
	Sell Protection					

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Source: UBS. Rating allocations are as of 31 March 2016.
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2.Percentage of companies under coverage globally within this rating category.
3.Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

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