

15 April 2021

## China Market Strategy

### Why Chinese Stocks Underperforming in a Recovery? Cues from Bonds

⊕ Recently, the default risk of some high-profile SOEs in China's credit market has become the focus with extended media coverage. While some of these SOEs, such as Huarong, are systemically important companies, the fact that they are systemically important and that they are majority government-owned implies that the default/bankruptcy risk is being monitored. After all, one cannot default on one's parents. And the US did bail out its entire banking industry in 2008. The significant mark-down on these SOEs' bonds is reflecting the latent risk that they are confronting.

⊕ Further, China's credit bonds are about 34% of the bond market. The entities issuing enterprise and corporate bonds are mostly central or local government SOEs, representing about 30% of the bond market that is worth ~RMB120trn. The majority of these bonds have been rated "A" or better, given their government connection and hence the perception of "guaranteed payment". It is understandable that such perception of "riskless" is now challenged given the circumstances.

Yet, it is difficult to fathom these bonds defaulting on a massive scale. The fact that some of the highly-rated SOE bonds are running into problems is a reflection of how the credit rating system has been blindly reflecting the principle of "guaranteed payment", rather than the varying credit risks. Even if these bonds are of different quality, there must be some good stuff in there. After all, owing money is frowned upon in Chinese culture.

⊕ Our data analysis shows that there are now <2% of total number of bonds outstanding and <1% of total principal outstanding that are in default. The principal of default bonds has risen significantly since the pandemic, but we must point out that they are a small part of the credit securities market, and even a smaller part of the overall China bond market. Further, our calculation shows that the EBITDA/interest cover ratio of the SOEs is 4-6 times on average, and should be more than enough to warrant against massive default risk.

The potential contagion risk, or the risk that default would be widespread, is more about perception than real. We would argue that, should the scale of default rise further from here, it should be a welcomed change to China's credit market. Finally, the market would break free from the "guaranteed payment" system. One simply cannot reform without taking some risk.

⊕ The return spread of high-yield vs. investment-grade bonds is now at one of its highest levels of the past decade, and appears to be rolling over. It hints at the market's waning risk appetite. When the spread was at this level historically, Chinese stocks rose when the high-yield performance didn't worsen further and risk appetite held steady, as in 2017, or fell when the high-yield tumbled, as in 2018 and early 2020. Given the milieu, we believe the high-yield will be under pressure in the near future, and will still be a drag on stocks that otherwise would have better reflected the economic recovery.

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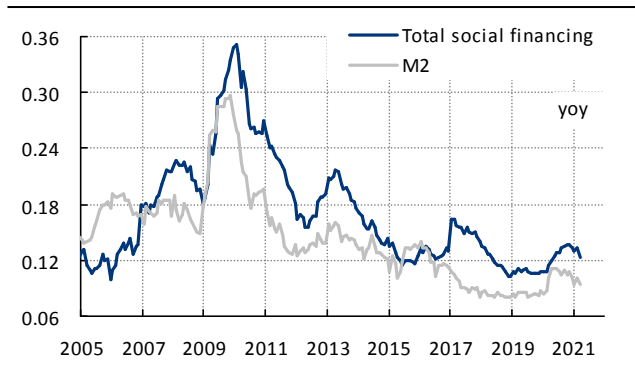
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**Figure 1: Return spread is rolling over from its highest levels of the past decade; it hints at the market's waning risk appetite**



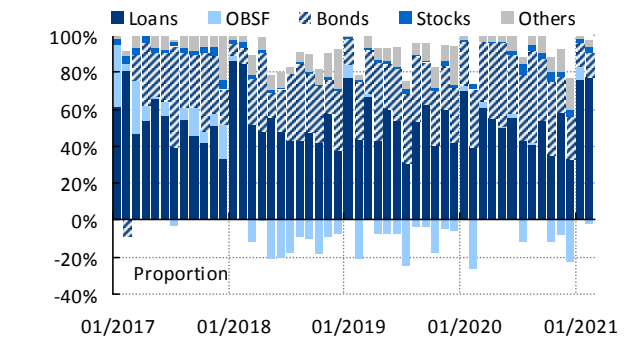
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**Figure 2: Credit growth has slowed since 4Q20**



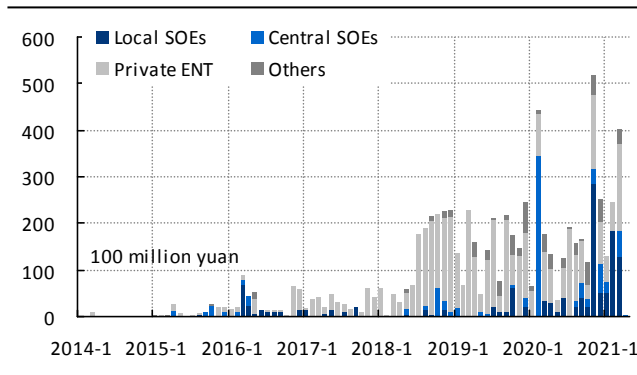
Source: Wind, BOCOM Int'l

**Figure 3: Bonds and OBSF drag down social financing growth**



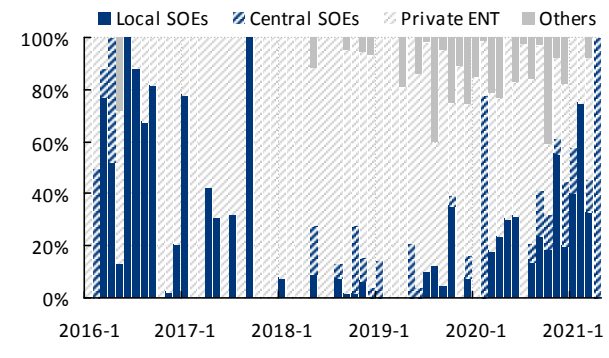
Source: Wind, BOCOM Int'l

Figure 4: Credit bond defaults rise



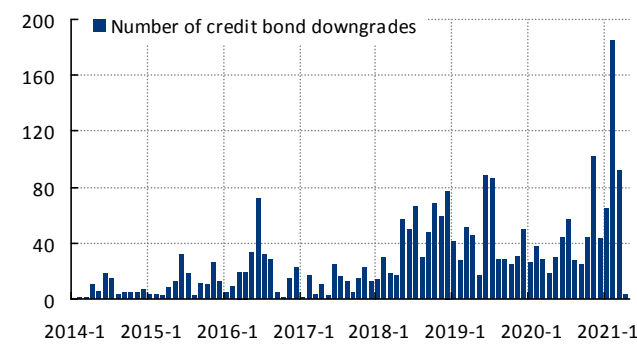
Source: Wind, BOCOM Int'l

Figure 5: Proportion of default scale of SOE bonds increases



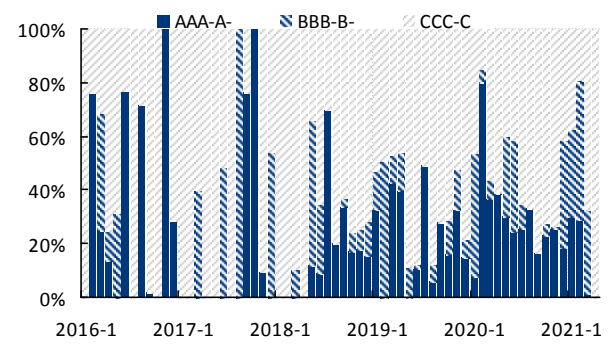
Source: Wind, BOCOM Int'l

Figure 6: Number of credit bond downgrades climbed



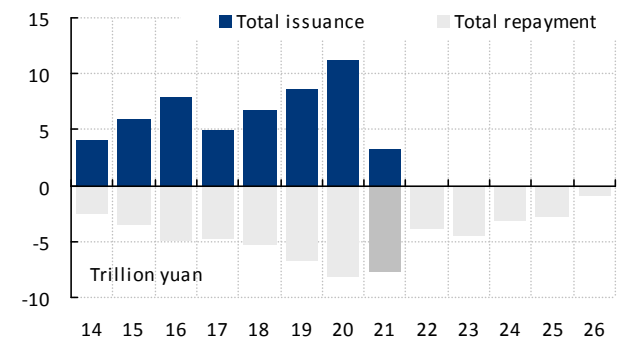
Source: Wind, BOCOM Int'l

Figure 7: Rating distribution of defaulted bonds' issuers



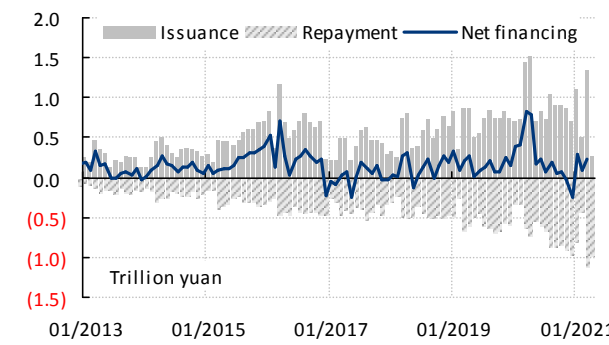
Source: Wind, BOCOM Int'l

Figure 8: Maturity pressure of credit bonds is heavy in 2021



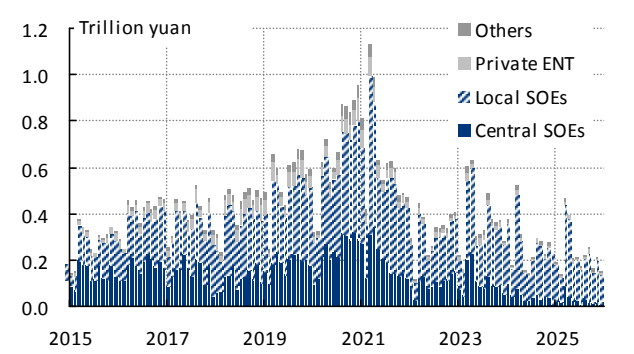
Source: Wind, BOCOM Int'l (Here the credit bonds only include enterprise bonds, corporate bond, MTNs, and short-term commercial paper)

Figure 9: With high credit risk, net financing amount turns negative



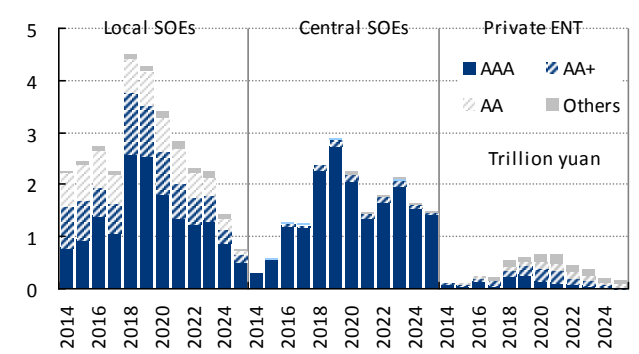
Source: Wind, BOCOM Int'l (Here the credit bonds only include enterprise bonds, corporate bond, MTNs, and short-term commercial paper)

**Figure 10: Credit bond maturity pressure is mainly on local SOEs**



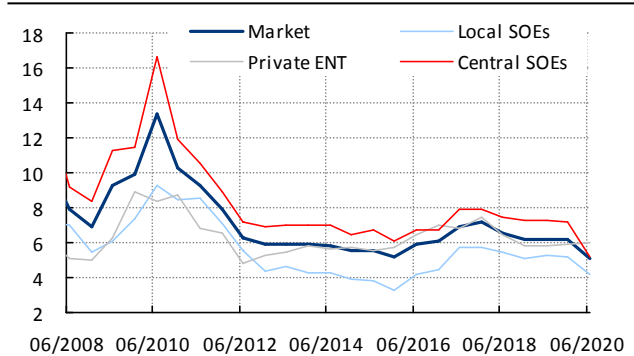
Source: Wind, BOCOM Int'l (Here the credit bonds only include enterprise bonds, corporate bond, MTNs, and short-term commercial paper.)

**Figure 11: Rating distribution of maturing credit bonds**



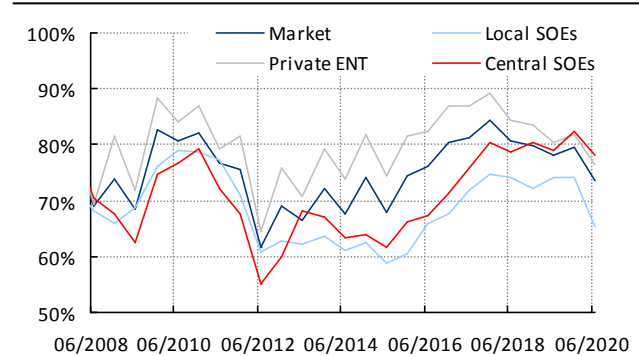
Source: Wind, BOCOM Int'l (Here the credit bonds only include enterprise bonds, corporate bond, MTNs, and short-term commercial paper.)

**Figure 12: EBITDA/interest expense ratio of China's listed companies**



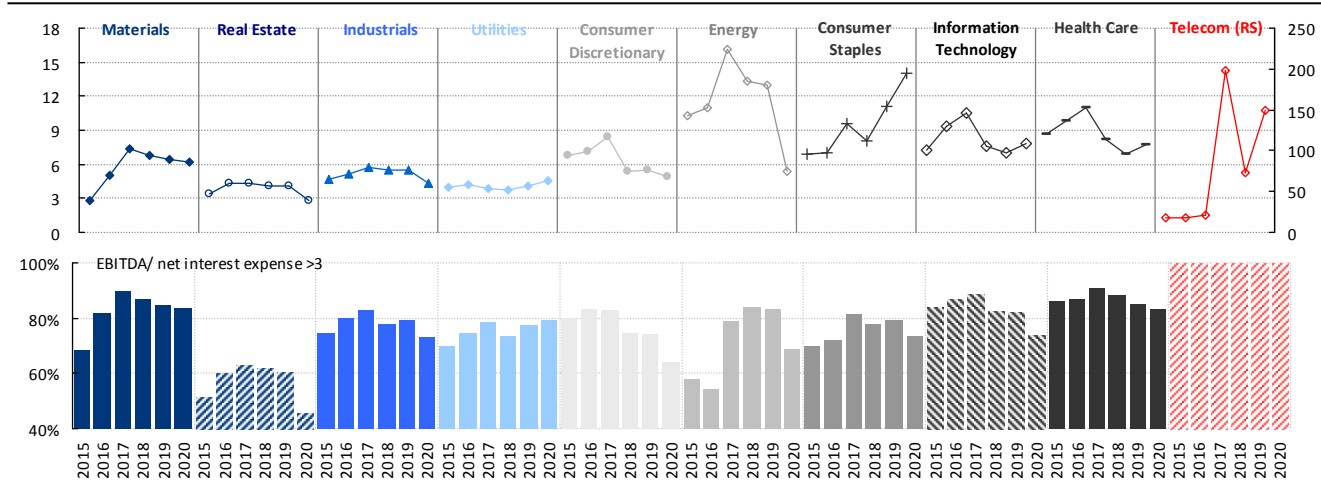
Source: Wind, BOCOM Int'l

**Figure 13: Proportion of China's listed companies with EBITDA/interest expense >3**



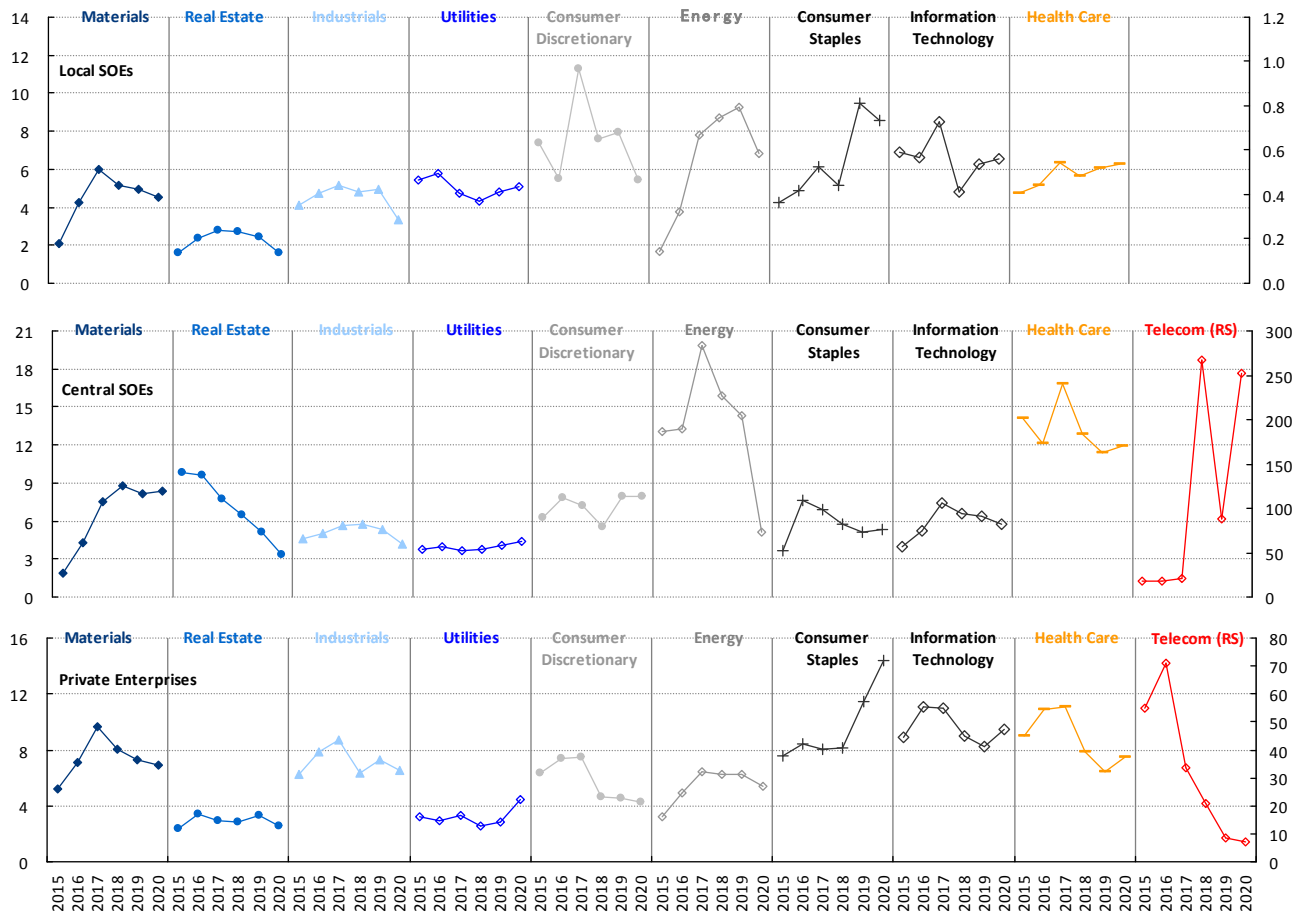
Source: Wind, BOCOM Int'l

**Figure 14: EBITDA/interest expense ratio of China's listed companies (by Industry)**



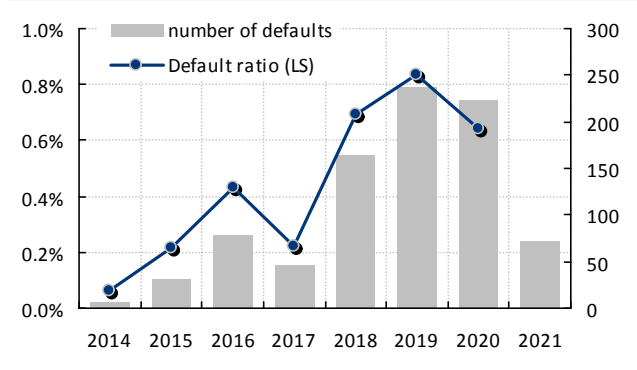
Source: Wind, BOCOM Int'l (Data up to 2020H1)

Figure 15: EBITDA/interest expense ratios of China's listed companies under various ownerships (by Industry)



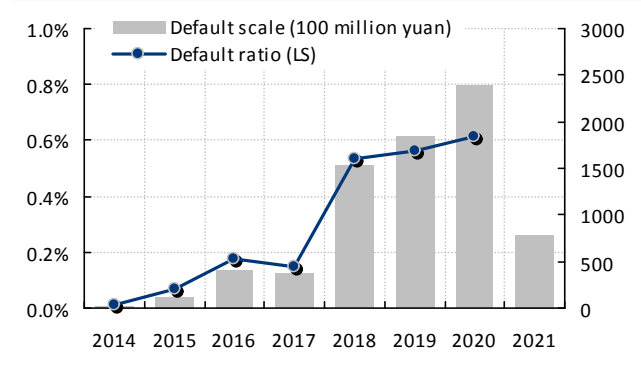
Source: Wind, BOCOM Int'l (data up to 1H20)

Figure 16: Default rate of credit bonds (by number of defaults)



Source: Wind, BOCOM Int'l

Figure 17: Default rate of credit bonds (by default scale)



Source: Wind, BOCOM Int'l

## Recent Reports

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20160217	Historic Lending! But Three Important Limits	20200207	Impact of nCoV outbreak on market and economy
20160301	No Growth, No Gain	20200210	Epidemic at turning point; economic cost of quarantine
20160307	Two-Sessions in a Cyclical Spring	20200224	Spell of liquidity easing
20160321	Unprecedented Divergences	20200228	The Curse of Plague
20160418	Sweet and Sour Hog Cycle	20200302	Unconventional Risk Hedging Strategies at Cycle's End
20160503	Ant Financial: A Unicorn's Defining Moment	20200309	Stock Market Populism
20160606	The Market Bottom: When and Where	20200310	Is China a "Safe Haven"?
20160613	The Great China Bubble: Anniversary Lessons and Outlook	20200316	Fighting COVID-19, Chinese Style
20160627	Post Brexit: How to Trade China.	20200323	Hopes and Hypes
20160817	Shenzhen-Hong Kong Connect: A New Era for China's Capital Market and Capital Account	20200324	The Fed Goes All In
20160822	Consolidation	20200330	Guesstimating Unemployment in China
20160912	The Most Crowded Trade	20200406	The Cycle Has Turned
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20170324	A Definitive Guide to China's Economic Cycle.	20200713	Running with the Bull
20170413	Price Inefficiency	20200720	3500
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20170828	A Definitive Guide to China's Economic Cycle Part II – New High	20200824	The Historic ChiNext Reform: What It Means and How to Trade
20170829	Cycle Sentiment	20201120	Outlook 2021: Value Strikes Back
20171114	Decoding disinflation : principal contradiction, social	20210327	Value Striking Back

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**Neutral:** The stock's total return is expected to be **in line with** that of the corresponding industry over the next 12 months.

**Sell:** The stock's total return is expected to be **below** that of the corresponding industry over the next 12 months.

**Not-Rated:** The analyst **does not have conviction** regarding the outlook of the stock's total return relative to that of the corresponding industry over the next 12 months.

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**Outperform:** The analyst expects the industry coverage universe to be **attractive** relative to the relevant broad market benchmark over the next 12 months.

**Market perform:** The analyst expects the industry coverage universe to be **in line with** the relevant broad market benchmark over the next 12 months.

**Underperform:** The analyst expects the industry coverage universe to be **unattractive** relative to the relevant broad market benchmark over the next 12 months.

Broad market benchmark for Hong Kong is the **Hang Seng Composite Index**, for China A-shares is the **MSCI China A Index**, for US-listed Chinese companies is **S&P US Listed China 50 (USD) Index**.



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