GLOBAL ECONOMY AND FINANCIAL MARKETS SHORT COMMENTARY

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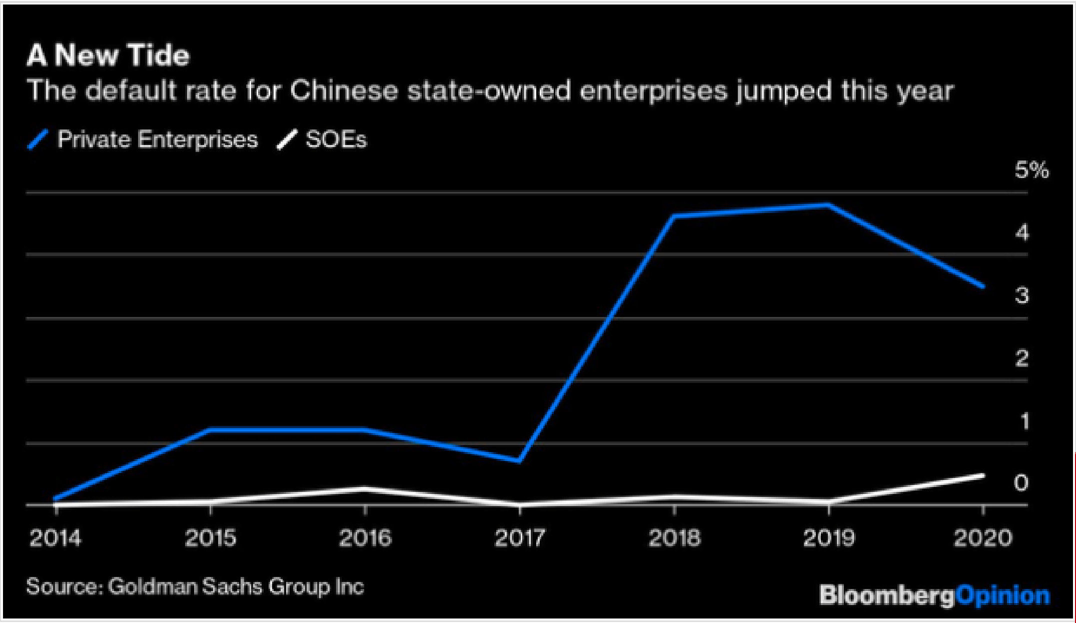
Recently, the default risk in China's bond market has increased significantly? Will it trigger a financial crisis?

A series of defaults on bonds issued by Chinese state-owned enterprise (SOEs) or affiliated companies has become a hot topic of the global financial market in the past few weeks, stoking unease about 'broader market contagion' and raising further structural problems.

Recently, there were several state-owned enterprises that have defaulted

- Huachen was backed by the Liaoning provincial government, which was unable to repay a 5.3% 1 billion yuan of "17 Hua Qi 05" corporate bond that matured on 23 October.
- Tsinghua Unigroup, founded by Tsinghua University in 1988, a manufacturer of chips and integrated circuits, which failed to meet its debt obligations on a 5.60% 1.3 billion yuan "17 Ziguang PPN005" bond which matured on 15 November due to short of liquidity.
- Coalminer Yongcheng Coal & Electricity Holding Group, indirectly owned by Henan provincial government, which failed to repay principle and interest on a 1 billion ultra-short term bond "20 Yongmei SCP003" due to short in liquidity, and this constituted a material default.

The default rate for Chinese state-owned enterprises

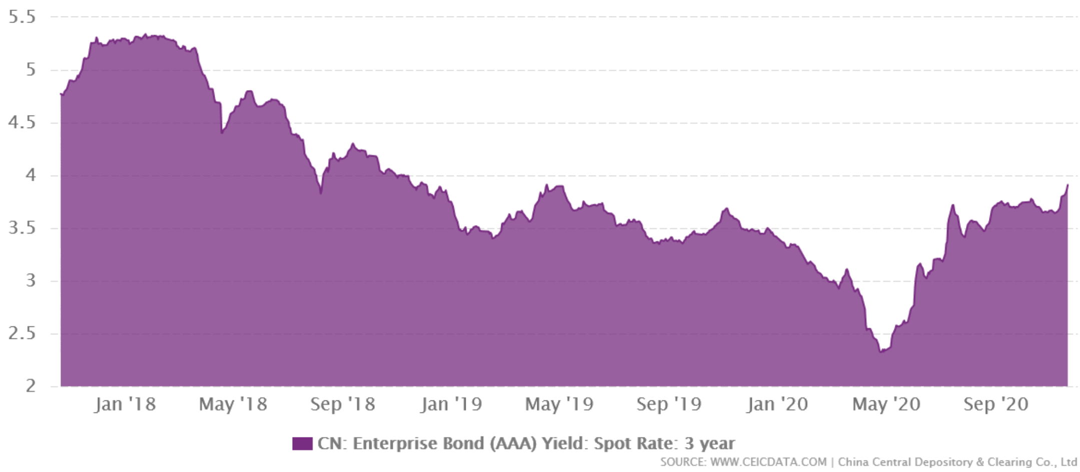


Sources: Goldman Sachs

Adding to the stress, the developments have rattled the entire China's corporate debt market and triggered investors' concern

- Last week, China's bond market recorded in suspended new bond issuance worth 19 billion yuan, all citing "recent market turmoil", which increased by 1.8 times from month to month. As at 16 November, the cancelled new bond issuance in November have reached 32.1 billion yuan.
- In addition to the cancellation of substantial amount of new bond issuance, the sour sentiment has pushed China's corporate bond yield to near 1.5 years high.

China 3-year corporate bond (AA) yield



Sources: CEIC Data

Due to increasing defaults recently, banks started to tighten the risk on bond investment and thus further worsen the problem in the bond market

Due to the increase of bond default happened recently, many banks in China had tightened their risk control measure in their regular investment on corporate bonds. Most banks had already restrained the power of their local branches, in terms of making decisions for bond investments. As a result, the declined investments from banks had further exacerbated the problems in the bond market.

If the above situation continues, it will have negative impact to some enterprises' financial status

For many enterprises, they need to borrow fresh funds from the bond market to repay their existing debt. Therefore, if the liquidity of the bond market decreases, it will affect their ability for debt refinancing. Besides, the higher bond yield will also increase the financing costs of enterprises, which will further increase their financial problem.

However, it should not be overly worried on the increasing trend for the breach of cases on Chinese stated-owned enterprises (SOEs)

The debt and liability problems in SOEs have aroused public awareness. However, the causes for the recent defaults are not due to any sudden structural change, nor any deteriorating financial situation in the Chinese market.

First of all, the ratio of the total amounts in breach cases remain a low level in the Chinese debt market, which accounted for 100 billion yuan YTD 2020, especially when it compares to the overall Chinese debt market of 100 trillion yuan, in which though corporate debt is only around 20 trillion yuan.

Furthermore, the instability of financial situations or debt problems in SOEs is not the new issues. The recent defaults in SOEs are only tip of the iceberg, in which it is expected that the hidden amounts are more than several times or even dozens of times. For historical reasons, some of the inefficient or lack of profitability SOEs are still supported and maintained by the Chinese government. Despite the recent breach cases, it does not imply that there is sudden economic recession in China or any severe deterioration in the financial positions. In the past, the default rate was relatively low/ or even nil in those insufficient or financially difficult SOEs, as the government will leverage its financial muscle to bail the company out and repay, such as granting more bank loans, lopping off its underperforming business and pledging to invest more capital into it or requesting other SOEs to take-over them. As a result, those low qualities SOEs still can survive in the market. The reasons of recent increasing of breach cases and breach cases changed from implicit to explicit may be just due to the choices of the Chinese government (though the occurring of COVID-19 this year had really led to financial loss to most SOEs).

Since a few years ago, the Chinese government has been pledged a new approach, with less unlikely to come to the rescue of financially struggled companies

Since the government ignored the increasing default cases of some state-owned enterprises in order to be more 'marketization', forecast that the default cases will be continued.

We believe the current situation is still controllable

Chinese regulators were likely to tolerate an increase in defaults, as they seek to let the market play a bigger role in discerning risk. It has become clearly that policymakers are removing support to struggling borrowers, even those backed by local governments and state-owned entities in the case of the recent defaults. As a result, it allows the differentiation in the Chinese market between stronger and weaker enterprises and also speeds up the process of market reforms.

If the government still offering supports to all SOEs in terms of covering all the interest and capital of the bond, there is no reasons for investors to distinguish strong and weak firms as they're guaranteed to receive the capital and interest.

But for investors

If the Chinese government continues to speed up the process of market reforms, it is expected that more SOEs with financial problems will be allowed to let go. Therefore, when investing in related bonds or stocks (or when doing business with related SOEs), investors must have a clear and better understanding of the companies.

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