Navigating the rising risks in China's bond market

Changes in government policy have impacted the Chinese bond market and highlight the importance of a prudent and in-depth research-based approach to investing in Chinese bonds. Fiona Cheung, Head of Credit, Asia from Manulife Asset Management shares her views on the latest market developments.

In recent years, the Chinese government has undertaken various financial reforms, including limiting debt issuance by local government funding vehicles (LGFVs), property sector cooling measures and a crackdown on shadow banking activities and sale of certain wealth management products. With the official growth target lowered to 7% for 2015, policymakers are likely to support an appropriate balance between ongoing structural reform and the need to maintain sufficient economic growth and employment going forward. In such an environment, investors should be mindful of how a change in government policy can impact investors, intended or otherwise.

Regulatory reforms push LGFVs to tap offshore bond market

One recent example of how government regulatory reform has impacted China's fixed income markets came as a result of a decree issued by the State Council in October 2014 which prohibited LGFVs from raising funds on behalf of the local governments. As a result of the decree, some LGFVs have had difficulty tapping the local banking and bond markets and are now turning to offshore markets to fund their operations.

For example, Qingdao City Construction Investment Group – the LGFV for the Qingdao municipal government – successfully issued US$800 million of offshore bonds in two tranches in early February. Despite the weak financial profile of Qingdao City Construction on a standalone basis, a number of rating agencies assigned investment-grade ratings to the bonds due to their belief of a very high likelihood of support from the municipal government should the LGFV run into trouble. As a result of this successful bond issuance, we believe that other LGFVs are likely to follow suit in tapping offshore bond markets.

Given the directive regarding LGFV fundraising for local governments, we are cautious in investing in offshore bonds issued by LGFVs from a risk-reward perspective unless we feel comfortable with the certainty and sufficiency of the level of financial support from municipal governments outlined in bond documentation. We do not assume government support unless it is explicitly stated.

Risks rising but not systemic

Credit risks are also rising, following a slowing in the Chinese economy and as evidenced by the increase in albeit still modest non-performing loan (NPL) ratios. According to the China Banking Regulatory Commission the NPL ratio of Chinese banks, including policy banks and rural credit organisations, increased to 1.64% in the fourth quarter of 2014, up from 1.49% at the end of 2013[1]. Despite these concerns, we do not view this as a systemic risk at the moment. We expect the Chinese government to allow selective defaults to occur if they assess that they are not likely to be highly disruptive or have a contagion effect on the financial system as a whole.

[1] http://www.shanghaidaily.com/business/finance/Chinese-banks-NPL-ratio-rises-to-5year-high/shdaily.shtml

While there has yet to be a clear default among Chinese companies, the increasing number of companies that have missed debt repayments highlights that this risk is rising. In 2014, Chaori Solar and Zhejiang Xingrun Real Estate both missed debt repayments. And in January, Kaisa – a Shenzhen-based property developer – missed a US$23 million interest payment on its US$500 million 2020 bonds. According to media reports[2], the company is currently being investigated by the government for graft. While the situation is yet to reach a resolution, Kaisa's financial troubles have undermined investor confidence in the company, particularly given the US$2.5 billion of offshore bonds it has outstanding and raised concerns that losses could spread to other companies in the sector.

The speed with which Kaisa's woes mounted caught many investors off guard, with related bond prices and investor sentiment negatively impacted as a result. The incident also highlights the lack of regulatory transparency that often accompanies any government intervention and the potentially negative impact on market and investor sentiment. It is also a reminder of the risks overseas bondholders face when Chinese companies run into trouble, China's bankruptcy laws favour local creditors while offering fewer protections to foreign debt claims.

Although any defaults would likely result in an increase in volatility in the Chinese bond market, we believe investors can insulate themselves from the worst of this fallout by ensuring that investment decisions are made on the basis of rigorous research into the standalone ability of a company to weather such a credit event.

Certain industries face headwinds

Certain sectors are also more vulnerable than others and we believe industries such as mining, steel and oilfield services will suffer more than others due to industry overcapacity, slowing economic growth and falling oil and commodity prices. In addition, we think that small private companies with high leverage, low operating efficiency, large refinancing needs and weak access to funding are particularly vulnerable.

Our Asia fixed income team advocates a Chinese fixed income investment strategy that leverages all three buckets of returns potential – currency, interest rates and credit. However, we feel that alpha based on careful corporate credit selection is increasingly important in the quest to maximise investment returns in China's rapidly growing but sometimes treacherous corporate bond market.

We are firm believers that diligent credit research by on-the-ground investment professionals and stringent security selection is the key to managing risk in Asian bond markets, including China.

[2] http://www.bloomberg.com/news/articles/2015-02-13/kaisa-investors-wary-on-bond-coupon-payments-next-month