China Watch

RECORD BOND DEFAULTS

China Team

Economics

- Value of bond defaults reaches record high
- Defaults reflect continued focus on deleveraging and moral hazard
- Neutral monetary policy favours government-linked bonds

Politics

- New anti-monopoly agency means deeper scrutiny for foreign firms
- Greater consistency in enforcement of anti-monopoly legislation
- QUALCOMM deal blocked as government seeks leverage in trade war

Markets

- Yuan devaluation and tax cuts for exporters in response to trade war
- Chinese growth not to be severely affected by likely escalation of trade war
- Accelerated bond issuance to bolster September data

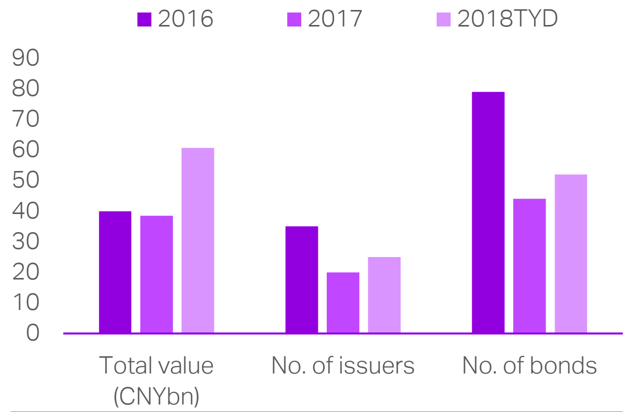
Economics: Monetary policy triggers yield divergence

- **Value of bond defaults reaches record high**
- **Defaults reflect continued focus on deleveraging and moral hazard**
- **Neutral monetary policy favours government-linked bonds**

Record defaults reflect policy tightening and higher tolerance towards credit risk. The value of bond defaults in 2018 has already reached a new annual high. This year, 24 companies have defaulted on 52 bonds worth CNY60.6bn (US$8.25bn). The year-to-date value is now 50% higher than the previous record of CNY39.9bn, recorded in 2016 (see Chart 1 below). There were five SOEs and one quasi LGFV among the troubled firms. The increase in defaults, which have been largely by overextended private firms, reflects tighter credit, Beijing's commitment to reducing financial risk and weaker corporate profit growth. We expect all three conditions to remain broadly unchanged over the short term and thus rates on high yield bonds to remain elevated. Beijing will fine-tune liquidity policy to avert the risk of a wider bond market sell-off.

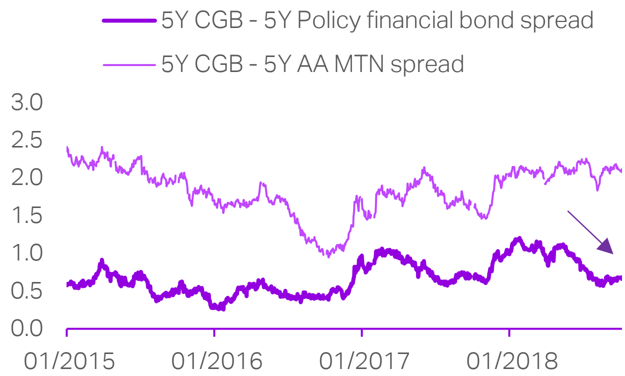
Neutral monetary policy favours state over private. Much has been made of the return to "easy money" following the State Council accommodative-policy statement in late July. We maintain that monetary policy is neutral and that financial risk control remains a priority, even though China is faced with a slowing economy and trade war with the US. The spate of bond defaults in Q3/18 and continued elevated yields on AA and below-rated notes underscores this view. The change to a *relatively* accommodative monetary policy has benefited, above all, the state sector. Banks continue to favour low risk lending to SOEs, local governments and large stable corporates. Meanwhile, funding for SMEs and smaller corporates remains tight. This is shown in the widening spread between five-year policy bond yields and five-year AA medium-term notes (MTNs) over CGBs (see Chart 2 below). Since March, policy bond spreads over CGBs have narrowed by 31 bps. By contrast, the five-year AA MTN yield spread have tightened and remain at their highest level for three years.

Chart 1: Record bond defaults



Sources: Reuters, TS Lombard.

Chart 2: Government-linked bonds favoured by monetary "easing"



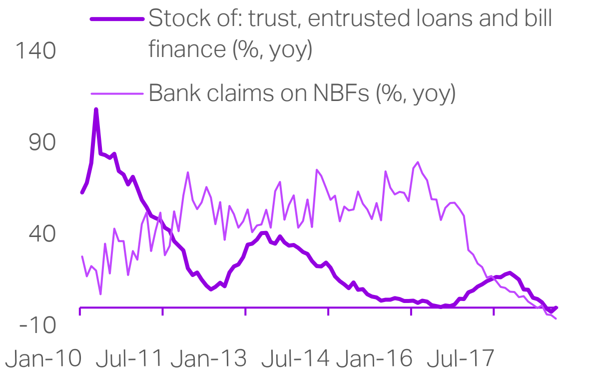
Sources: TS Lombard, CEIC.

In China, the volume of credit supply, not the price, is important. This is because private companies often have difficulty tapping into official fund sources – essentially, they are price-takers. Thus far, PBoC "easing" has not provided sufficient volume of credit to induce banks to lend to riskier, but more dynamic sectors of the economy, resulting in the aforementioned yield divergence. The bank is working on improving policy transmission; however, its effectiveness is unlikely to change in the short term and the preference for state over private bonds will remain. We expect data released on Friday to show total credit recovering and we anticipate TSF growth to rebound from the current level of 11.4% in August to around 12.5-13% by the end of this year and to 14.5% in 2019. This will provide some scope for additional funding for higher-yielding notes. Nevertheless, government-linked debt will still be preferred and the divergence in yields will persist.

Shadow banking contraction pressures high yield bonds. Owing to tighter credit conditions and stricter macro-prudential rules, it has become harder for companies to secure access to funding either in the bond market or from shadow banking in general. This is a problem for lower-rated corporates, in particular, since it impairs their ability to roll over maturing debt. Previous avenues of off-balance sheet financing have been removed, and/or cut dramatically. The outstanding stock of trust loans, entrusted loans and bankers' acceptances have eased significantly – from 15.3% yoy in December to -2.3% in July. More broadly, the slowdown in shadow banking activities is reflected in the slower growth of bank claims on non-bank financial institutions -6.03% yoy in July (see Chart 3 below). Deleveraging will not be reversed and funding pressure on riskier corporates will continue.

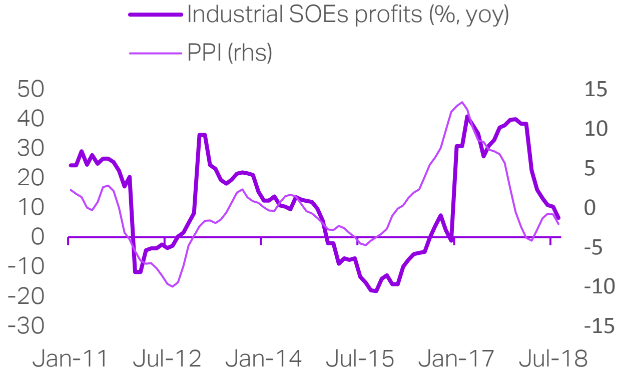
Corporate profits pressure loan repayment. A slowdown in corporate profit growth has compounded liquidity issues. Reduced cash flow to corporates limits their ability to repay debt and makes them less attractive as borrowers. Unsurprisingly, the majority of private company defaults in 2018 have been by firms that had seen a deterioration in profits and rapid balance sheet expansion in recent years. We expect profit growth to continue to slow through H2/18 in line with nominal GDP, adding further pressure to corporate debt. More than one third of bond defaults in 2018 had been issued by firms operating in the traditional economy, namely energy and construction. This is predictable given the slowdown in investment and PPI (see Chart 4 below). We expect defaults to continue to be concentrated in this area. The impact of supply-side reform and environmental production restrictions on PPI is weakening, harming industrial profits and thereby weakening firms' repayment ability.

Chart 3: Financing for high-yield bonds tightens



Sources: CEIC, TS Lombard.

Chart 4: Corporate profits under pressure



Sources: CEIC, TS Lombard.

Gradual reduction of moral hazard

Table 1: Historic first bond defaults

Mar-2014	Private company (Chaori solar)
Apr-2015	Local SOE (Baoding Tianwei)
Apr-2016	Large centrally controlled SOE (China Railway Materials)
May-2018	LGFV delays loan repayment (Xilinhot Geipaishui Co)
Aug-2018	LGFV technical default (6th Division Xinjiang Production & Construction Corps)

Beijing is focused on risk repricing. We have previously noted that Beijing is undertaking a multi-year programme to reduce moral hazard and "reprice risk". A differentiated, truly risk-adjusted bond market is a long-term goal of the authorities. Since the first bond default in 2014, Beijing has slowly allowed increasingly important entities to default on their debt. Table 1 above highlights the escalation from private defaults, to local SOE and then to centrally controlled SOE. We believe the process will eventually lead to a LGFV default. The technical/late payment by the Sixth Division of Xinjiang Production & Construction Corps (XPCC), a quasi LGFV, in August, is the next significant marker on this route.

LGFV default will be delayed. While we are confident about the end destination, we believe there will be no LGFV default this year. The aforementioned preference for state over private means liquidity provision for local governments should be sufficient to prevent undue LGFV stress. In addition, the accelerated bond issuance mandated by the authorities will further add to provincial liquidity buffers. The fast-tracked general and special bond issuance in September and October (local governments have to meet no less than 80% of their annual special bond net issuance quota by end-September and the remainder in October) are nominally for infrastructure investment. In reality, local officials will be able to guide funding to LGFV or local SOEs in need of financing. There is a final political angle to LGFV defaults: given the trade war, Beijing is unlikely to risk allowing weakness in a government entity so embedded in the financial system.

Xinjiang points the way. The technical default by XPCC indicates Beijing is still determined to reduce moral hazard on China's bond market. On the surface, XPCC'c late payment in August, after receiving a rapid infusion of CNY 500 million appears typical of the tacit guarantees Beijing wishes to remove. However, a closer examination shows that instead of simply receiving government funds, XPCC had to go to the market and pay a punitive rate for a 270-day loan. While the loan may have been mandated by the central authorities, the imposition of a penalty rate for defaulting is a step towards reducing moral hazard. The immediate aftermath saw a brief sell-off in LGFV bonds, particularly those based in Xinjiang. Historically, the market has been slow to price in the removal of implicit state guarantees and there is some way to go before markets accurately price in the risks associated with potential LGFV defaults.

Pressure on high yield bonds will continue as Beijing maintains its focus on deleveraging and financial risk prevention while the economy softens. However, systemic risk is low and the authorities will fine-tune liquidity provision to maintain both financial market stability and economic activity.

Politics: Beefed-up anti-monopoly agency

- **New government anti-monopoly agency means deeper scrutiny for foreign firms**
- **Greater consistency in enforcement of anti-monopoly legislation**
- **QUALCOMM deal blocked as government seeks leverage in trade war**

China has merged three antitrust enforcement bureaus into one ministerial level agency, the State Administration for Market Regulation (SAMR), which began operating at the end of September. The formation of a single centrally administered ministry heralds increased government control and improved consistency in anti-monopoly (AM) investigation and enforcement. Crucially, the agency will be directly supervised by the State Council, signalling that the government is placing more importance on antitrust mechanisms.

We expect the merger of the three defunct regulators to reduce the number of AM investigations. Previously three separate bureaus- the Anti-Monopoly Bureau of the Ministry of Commerce (MOFCOM), the National Development and Reform Commission (NDRC), and the State Administration of Industry and Commerce (SAIC) - all managed some aspect of antitrust regulation. Collectively, they had a turnover of cases totalling more than CNY10bn last fiscal year. Under the old system, inter-bureau competition was encouraged with ambitious bureaucrats all wrestling for high-profile cases. The consolidation of the three entities into SAMR means bureaucratic competition has been drastically reduced, thereby decreasing the frequency and haphazard nature of investigations.

The lack of coordination between the three bodies had the perverse effect of bureaucratic overreach, with each going beyond the limit of their power. In 2016 Tetra Pak faced a hefty US$97m fine for abuse of dominant position, specifically for the practice of bundling. The judgement related to a price violation, which was an area not covered by the mandate of the prosecuting body, the SAIC. For foreign firms operating in China, clarity on where regulatory authority lies is essential; thus the unification into one entity will make it easier to coordinate relationships with regulators.

There could also be the benefit of quicker regulatory approval for M&A. Chinese regulators are known to take their time, asking for more documentation than any other regulator. For example, the sell-off of Toshiba's subsidiary, Toshiba Memory, was delayed by several months owing to lengthy reviews by Chinese regulators. Such delays could be minimized in future.

Foreign companies already face more M&A scrutiny than local firms. Data compiled by the Rhodium Group, show that mergers of foreign companies are six times more likely to be reviewed by authorities than are deals between two Chinese firms. Chinese regulators notably withheld approval for QUALCOMM's US$44bn bid for Dutch chipmaker NXP in July of this year, after the eight other relevant jurisdictions had approved the deal. The high-profile nature of the deal meant that by blocking it, the Chinese demonstrated that they have leverage in the broadening conflict between US and Chinese economy. While China showed the business community its capacity to retaliate in this case, a series of deals (listed in Table 1 below) approved by Chinese regulators amid trade tensions shows that blocking foreign M&A is by no means a codified policy.

Table 1: Chinese approval of foreign M&A

May-2018	Authorities approve Microchip Technology's US$8.35bn bid for Microsemi
May-2018	Bain Capital's US$18bn acquisition for Toshiba's microchip unit approved
Sep-2018	Takeda obtains SAMR approval for Shire acquisition
Oct-2018	SAMR approves The Linde Group acquisition of Praxair

It remains unclear whether the government, which now has a tighter grip on anti-trust enforcement, will utilize the beefed up SAMR to gain leverage in the trade war. SAMR's ongoing review of both the Walt Disney US$71m acquisition of 21st Century Fox and the United Technologies US$30bn acquisition of Rockwell Collins, both of which have been cleared by US regulators, will provide an indication as to whether the agenda of foreign, especially US-based companies will be frustrated by Chinese regulators.

Being invited for "tea" with an SAMR authority is a key indicator that the regulatory body is initiating an antimonopoly investigation. Company representatives are normally brought in for a cup of tea and questioning several months before the start of an official probe. This trait was highlighted by the probe into Samsung Electronics, SK Hynix, and Micron Technology (the three biggest players making DRAM memory chips) for price fixing. The authorities reportedly met with Samsung in late 2017 to discuss rising DRAM prices. Investigations in the US and specific complaints from Chinese firms followed in Q1/18, culminating in the semi-conductor price probe in June of this year. All three firms reported that officials from SAMR had paid visits to their offices recently.

SAMR is headed by Zhang Mao, but we believe that Wang Yong, a central committee member and former director of the State-Owned Assets Supervision and Administration Commission (SASAC) is the man to watch. Wang chaired the inaugural meeting of the SAMR committee; and given his political stature, it is expected that he will be central to SAMR leadership and the setting of antitrust policy. The other member worth following is Gan Lin, deputy minister of SAMR, who has been assigned to oversee antitrust enforcement. She recently issued a statement saying that SAMR will strengthen enforcement in telecoms, pharmaceuticals, agriculture, and chemical materials.

The procedure for designating sectors or companies for investigation remains opaque. Some level of political consideration and industrial policy has evidently been involved on previous occasions. However, the motives for an AM investigation can vary considerably and it is difficult to specify single issues. In the past, foreign technological dominance in strategic emerging industries has triggered investigations, although this is not a rule of thumb.

Work remains to complete agency consolidation. At the provincial and city level, the three former agencies are still operating independently. Merging the various antitrust branches will require several months of administrative work. In the intervening period, any investigations carried out by provincial agencies can be treated as inconsequential "noise". Investigations will carry weight only if officially taken up by SAMR.

Markets: Response to trade war

- **Yuan devaluation and tax cuts for exporters in response to trade war**
- **Chinese growth not to be severely affected by likely escalation of trade war**
- **Accelerated bond issuance to bolster September data**

President Trump's second round of tariffs on US$200bn of US imports from China was set at 10%, not the 25% that markets had feared. Although markets rallied on the news, Trump had said he would raise the tariff level to 25% in January if China retaliated, which it did a few days later. What is more significant, though, is that US-China economic conflicts have now led to a falling out in political and military relations, as a result of which renewed trade talks appear quite unlikely. On 20 September the US imposed secondary sanctions on the military's Equipment Development Department and its director for purchasing Su-35 combat aircraft and an S-400 surface-to-air missile system from Russia; this controversial move has led to cancellations of high-level military meetings. Buoyed by his apparent success in re-negotiating NAFTA, we expect Trump to continue escalating his trade war with China, eventually reaching 25% on the bulk of goods that China exports to the US by Q2/19. We also expect that, faced with such US moves, China will seek to deepen economic ties with its neighbours and with foreign firms rather than try to match new US tariffs. Indeed, it is already cutting existing tariffs for non-US imports and more flexible policies towards FDI, including allowing 100% ownership, are likely.

A full-scale escalation of Trump's trade war will push China's current account into deficit and lead to yuan depreciation of up to 15% by mid-2019. Our call for yuan depreciation was non-consensus when we made it in early August but is now increasingly echoed by other analysts. Further, we do not think an escalation of the trade war will lead to across-the-board monetary and fiscal stimulus. Rather, policymakers will likely target stimulus to the affected export sector rather than risk undermining their deleveraging efforts by introducing broad economic stimulus; yuan depreciation and tax breaks for exporters are the least risky policy options. Although it is true that yuan weakness triggered significant capital flight in 2015, the government has since tightened controls on potential outflows so that a 15% depreciation in our view is unlikely to spur large-scale capital flight.

Data show that the economy is slowing, primarily for domestic policy reasons – not yet because of tariffs. Infrastructure spending has been the main drag on growth so far this year. FAI in infrastructure is down 5% ytd, largely because local governments failed to make use of their loan quotas earlier this year, fearing the monetary authorities would crack down on their rising levels of indebtedness. At mid-year the government instructed them to start investing in local infrastructure projects once again. In August and September local authority bond issuance soared, exceeding the amounts raised in the previous six months. New spending is now in the pipeline and will show up in the economic data later this month.

Macro views

Politics	China is determined to fight back against US trade policies
Economics	Growth is now slowing; we project 6.3% in H2/18 and 6.5% for the full year

Macro data

	Latest	Next 3–6 months
Inflation yoy%	2.1	Inflation rising to 2.5% in Q1/19
GDP growth%	6.7	6.3% in H2/18 and 6.5% on average for 2018

Markets

Equities	+1(-1)	Equities likely to rebound following the recent selloff
Currencies	-1(-2)	Additional tariffs likely to be followed by further yuan depreciation
Local rates	-1	Following recent easing, interest rates are likely to be stable to higher

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