

Special Comment

# 2015 Outlook: China's Economy and Bond Markets

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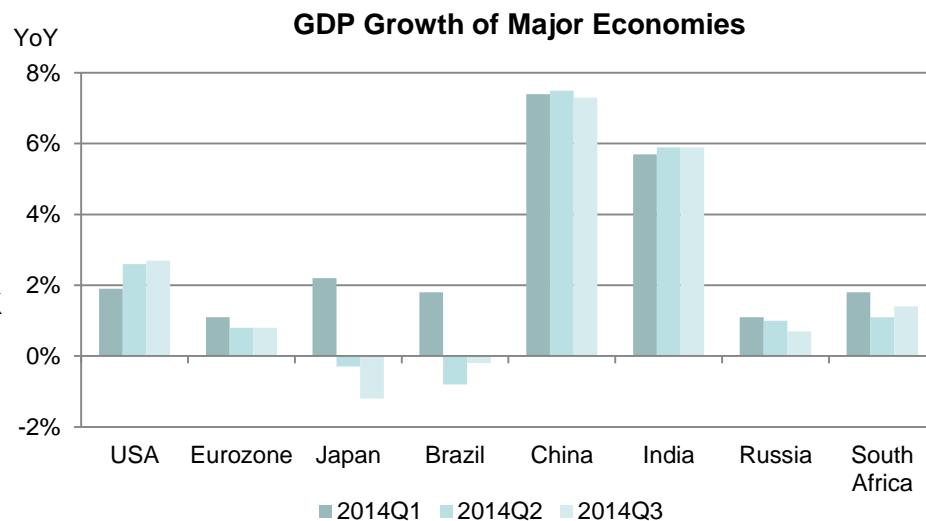
# Summary

- Economic performance of the developed economies shows discrepancies, while that of the emerging markets is under pressure of geopolitical risk and slow recovery of the global economy. Looking forward, we expect the global economy will grow at about 3.2% in 2015.
- China's GDP growth will continue to ease as the country is undergoing economic rebalancing. Chinese policymakers focus more on the economic reform and the stability of financial systems.
- The onshore RMB bond market is heading towards further market liberalization. Chinese regulators have implemented guidelines aimed at diversifying the market and disciplining issuers.
- The offshore RMB bond market is expanding beyond Hong Kong to other financial centres such as Singapore, Taipei, London, Frankfurt, and Sydney. The internationalization of the RMB has progressed significantly.

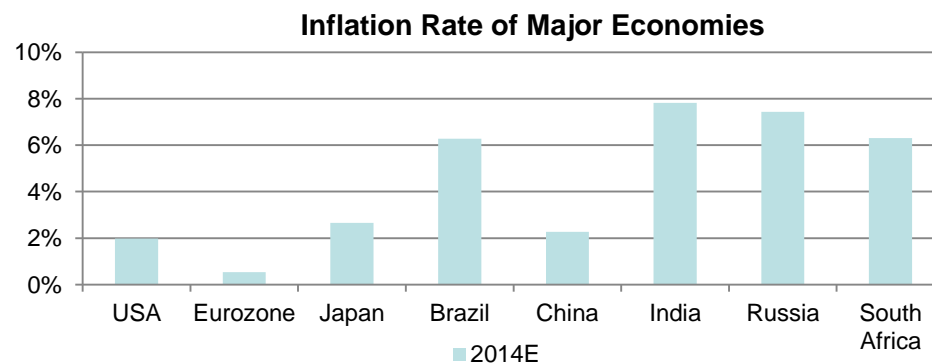
# Global Economy

## 2014 at a Glance

- Discrepancies in major developed economies
  - US recovered with accelerated growth
  - Eurozone remained sluggish, at risk of deflation
  - Japan missed both economic growth and inflation targets
- Slowdown in the emerging markets
  - India and China remained as outperformers albeit in correction
  - South Africa and Brazil kept struggling
  - Russia's economy was shrinking given weak ruble, low oil prices, and high inflation



Sources: OECD Stat, Federal State Statistics Service of Russia & Statistics South Africa



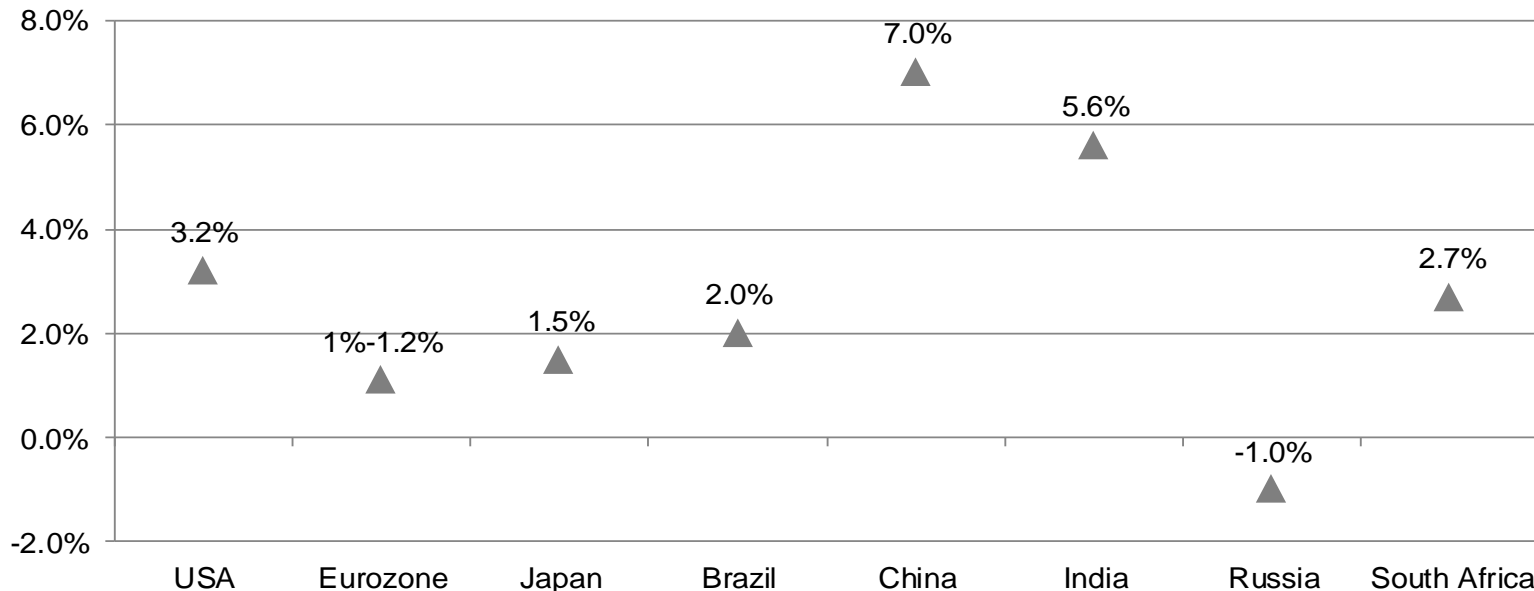
Source: IMF

# Global Economy

## 2015 Outlook

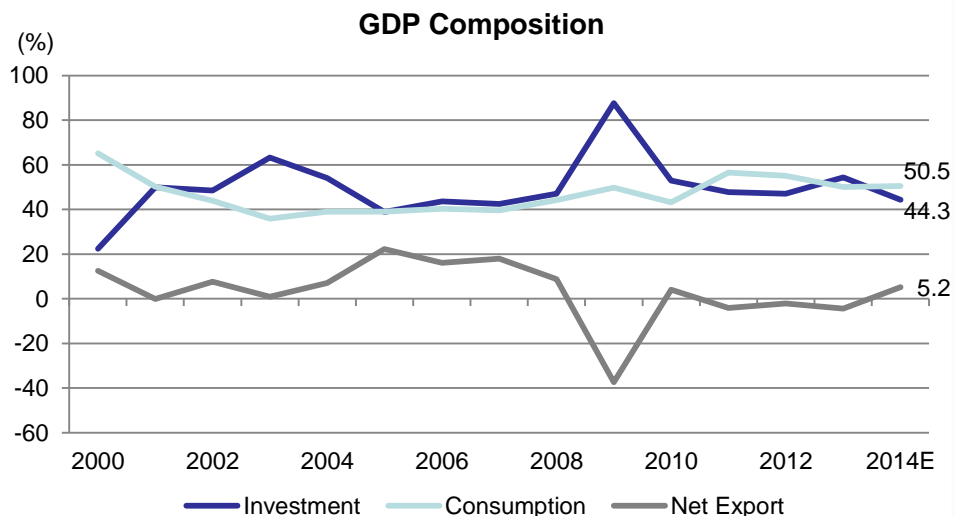
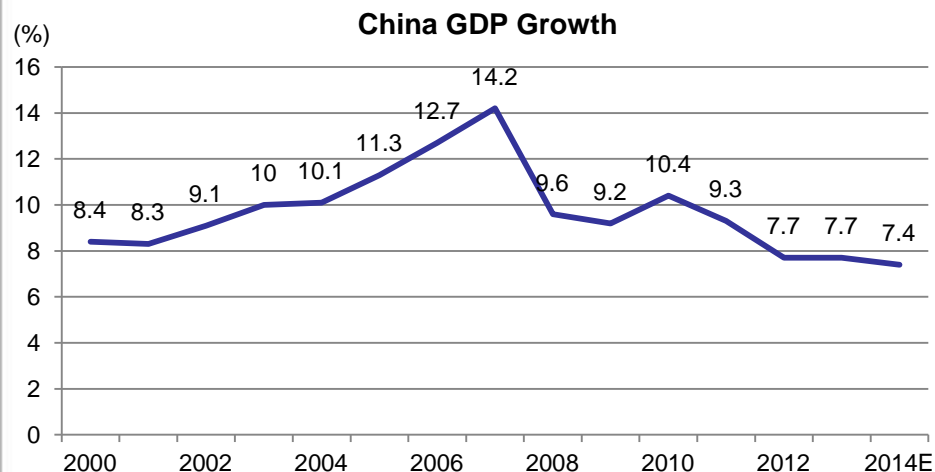
- The US continues to recover, with an expected interest rate hike in the second half.
- Japan and the Eurozone show modest improvement.
- Prospects in emerging markets depend on the pace of structural reform.
- Global GDP is expected to grow by 3.2% in 2015.

**GDP Growth Forecast for 2015**



# China's Economy

- China's economy is rebalancing towards a “new normal”. With the shift to a consumption-driven economy, we expect China's GDP will ease to about 7% in 2015 from 7.4% in 2014.
  - Fixed asset investment* The government will continue to invest in infrastructure, while the issues of overcapacity in manufacturing and excess supply in property will prevail.
  - Consumption* The government is formulating a new growth model to stimulate consumption in areas such as information, environment, healthcare, retirement, and leisure.
  - Net export* China's imports and exports will become more integrated with global trade.

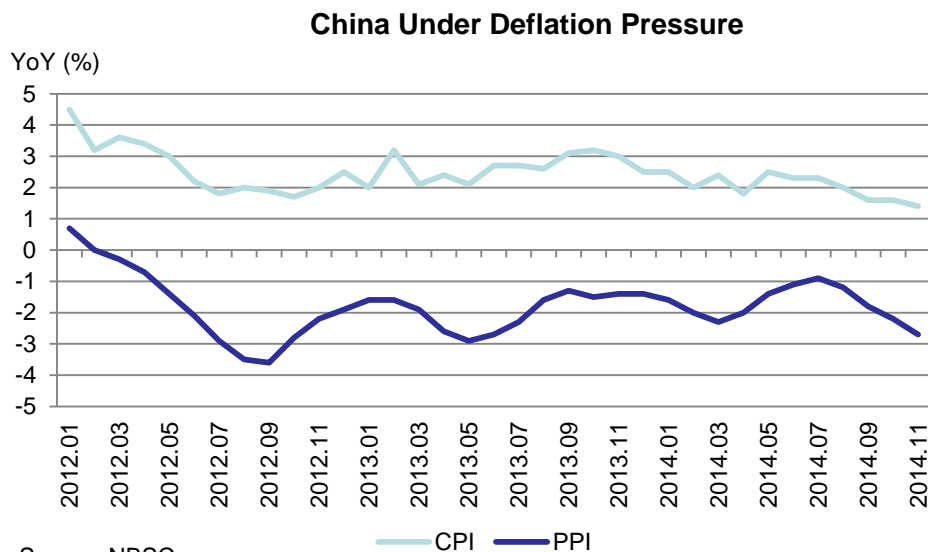


Source: NBSC, CCXAP research

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# CPI and PPI

- Since 2012, China has been in a climate of low CPI and negative PPI due to weak domestic demand and falling commodity prices. CPI dropped to a five-year low and PPI continued to fall.
- Deflation can amplify debt burdens, causing an adverse impact on highly leveraged companies and the overall economy. Therefore, China is in need of a supportive monetary policy to mitigate the deflation risk.



Source: NBSC

# Monetary Policy and Fiscal Policy

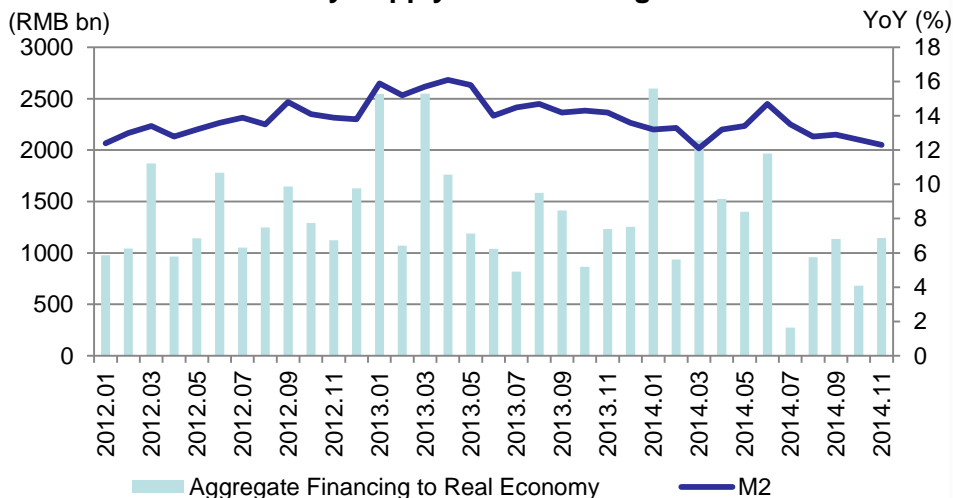
- China's monetary policy will remain accommodative, and there will be an appropriate balance between loosening and tightening.
  - The mini-stimulus measures and targeted easing tools achieved little effect in 2014.
  - In November 2014, the central bank lowered the benchmark lending and deposit rates. Given the correction in economic growth and increase in deflation pressure, further interest rate cut will likely happen in 2015.
  - In December 2014, the central bank expanded the base for calculating loan-to-deposit ratios and relaxed the requirement of additional reserves by the banks.
- As the central government is taking a proactive fiscal policy stance, an increase in the aggregate budget deficit is expected. Fiscal resources will be reallocated to manage government income and expenditure more effectively.

## Interest Rate Adjustments

	6Jul2012	22Nov2014
one-year lending rate	6%	5.6%
one-year deposit rate	3%	2.75%

Source: PBOC

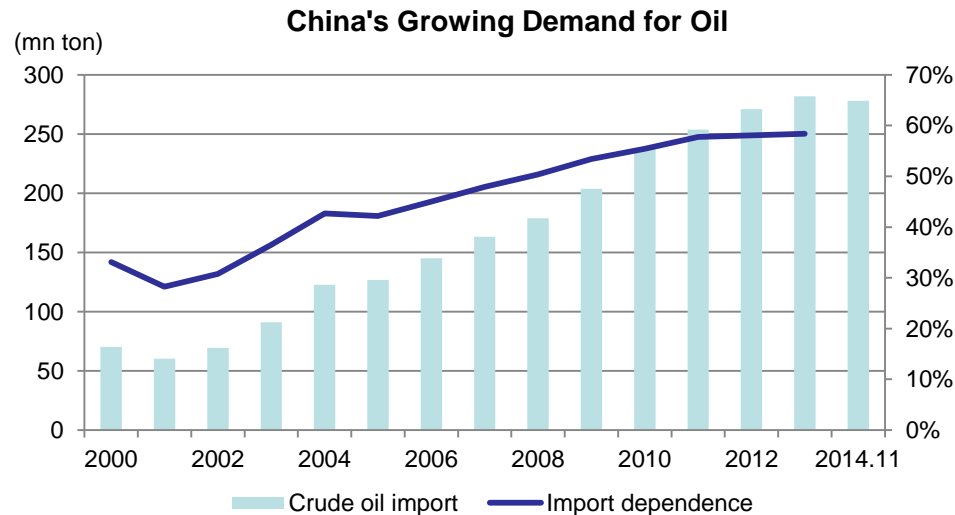
## Money Supply and Financing Activities



Sources: NBSC, PBOC

# Crude Oil Price

- Affected by the structural change of global energy dynamics, crude oil prices have decreased considerably, falling by more than 50% since mid-2014.
- Despite concerns over deflation, we expect China will largely benefit from the fall in oil prices, allowing more room for Chinese policymakers to ease monetary policy.
  - China is now the world's second-largest importer and the largest net importer of crude oil. Close to 60% of its domestic oil consumption relies on foreign supplies. Thus, the oil price slump translates into huge amount of foreign exchange savings.
  - Heavy users such as manufacturers and transportation companies will benefit the most from low oil prices. Private car owners will also benefit albeit the effect is partially offset by the increase in consumption taxes on oil products.



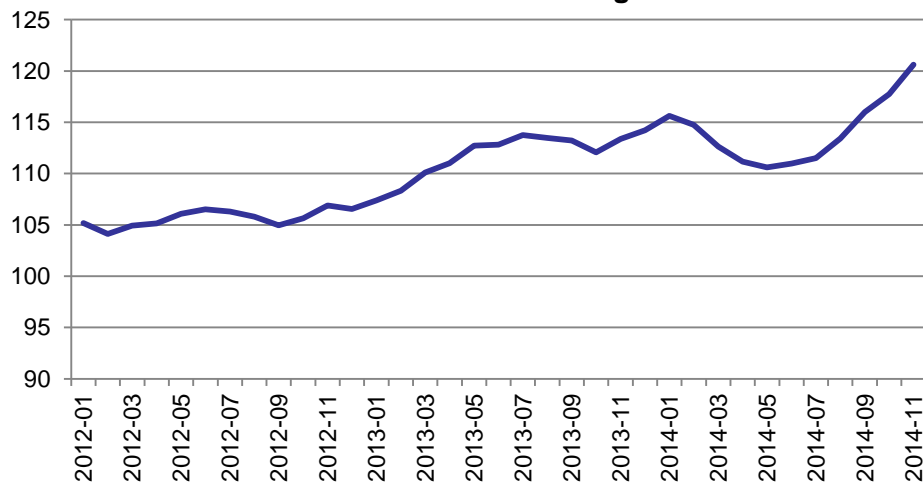
Sources: NBSC, China Customs



# RMB Exchange Rate

- The RMB valuation is approaching an equilibrium. Given the strong economic recovery of the US, the RMB is under pressure of depreciation against the USD. Although the daily floating range has been widened to 2%, the RMB exchange rate will be confined within an appropriate range. Since depreciation is unfavourable to the internationalization of the RMB, a sharp fall will be less likely.
- Further improvement in exchange rate regime will help reduce the costs of central bank intervention, and enhance independence of monetary policy and liberalization of capital account.

RMB Effective Exchange Rate



Source: BIS

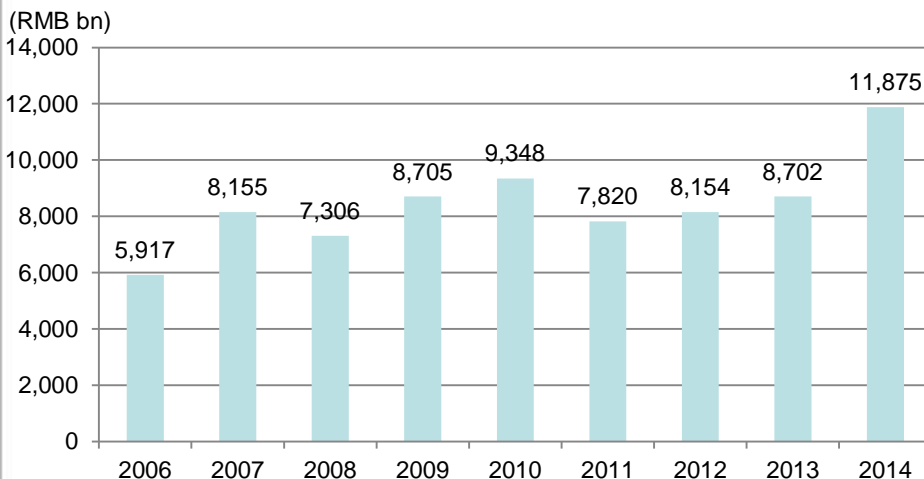
RMB Exchange Rates Against Major Currencies



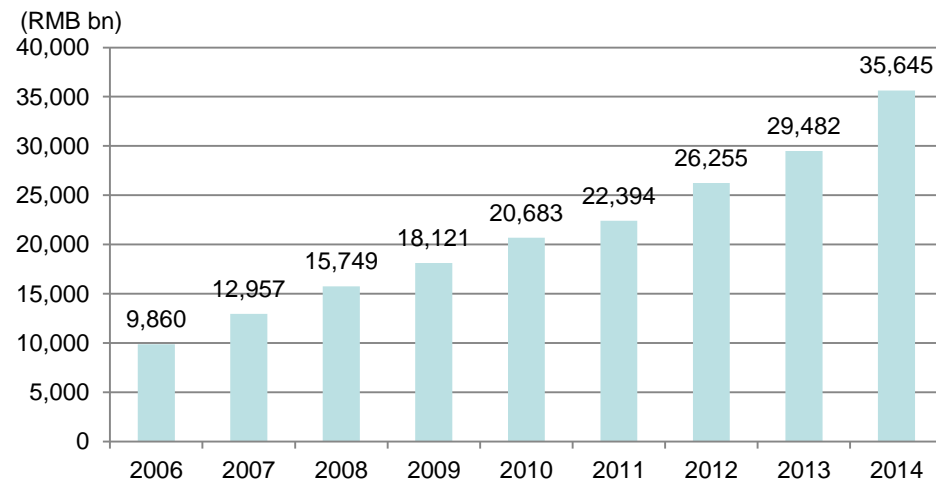
# RMB Bond Market – Onshore

- Onshore RMB bonds are traded in the interbank market and on the exchanges. Product innovations such as project revenue notes, perpetual bonds, supply chain notes, M&A bonds, exchangeable bonds, and Basel III bonds emerged in 2014.
- China's capital markets are in need of more diversified financing alternatives to meet the funding needs of different companies. A mature bond market contains issues of different credit levels, matching expected returns with expected risks. Market liberalization will help the bond market in achieving sustainable development.

### Issuance Amount



### Outstanding Amount



Sources: Gildata, Chinabond

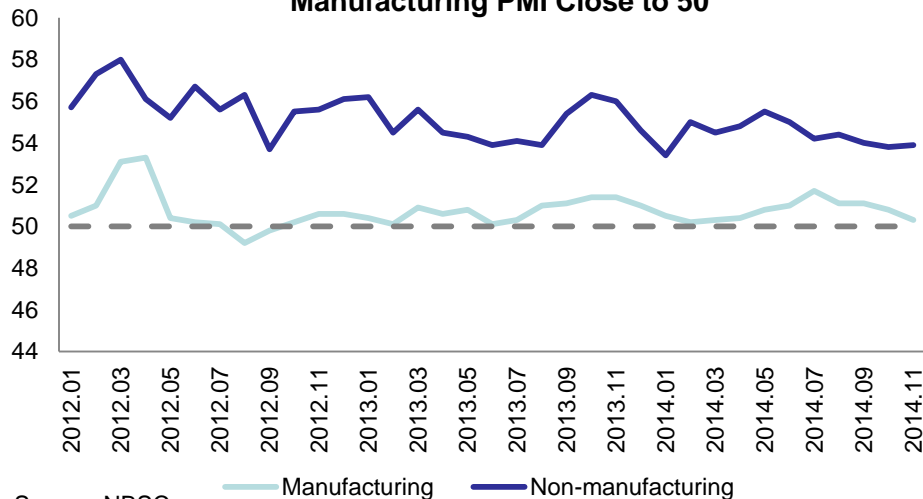
Sources: Gildata, Chinabond

# RMB Bond Market – Onshore

## Credit Risk: Fundamentals

- Manufacturing industries are facing the situation of overcapacity, operating downturn, and high leverage. As the economic growth is expected to decelerate, China will experience more companies running into repayment difficulties.

Manufacturing PMI Close to 50



Source: NBSC

## Rating Downgrades

Industry	Downgrades
Mechanical equipment	14
Power equipment	7
Coal	6
Photovoltaic solar	5
Steel	4

Source: CCXI

## Liability Ratios

Industry	Liability Ratio
Steel	67%
Petrochemical	66%
Coal	66%
Recycling	65%
Power generation	65%

Source: NBSC

# RMB Bond Market – Onshore

## Credit Risk: Credit Event

- In 2014, the onshore market recorded the first public bond default and increasing number of credit events in private placement bonds, SME collective bonds, and guarantee companies.
- SMEs face high operating risks and lack track records, thus come with higher credit risks. However, given their low market share, discrete defaults will have limited impact on the bond market.
- China moved to separate local government debt from corporate debt. Some state-owned enterprises may no longer receive implicit guarantees, so they will be accountable for their own debts.
- We expect more credit events to occur in 2015.

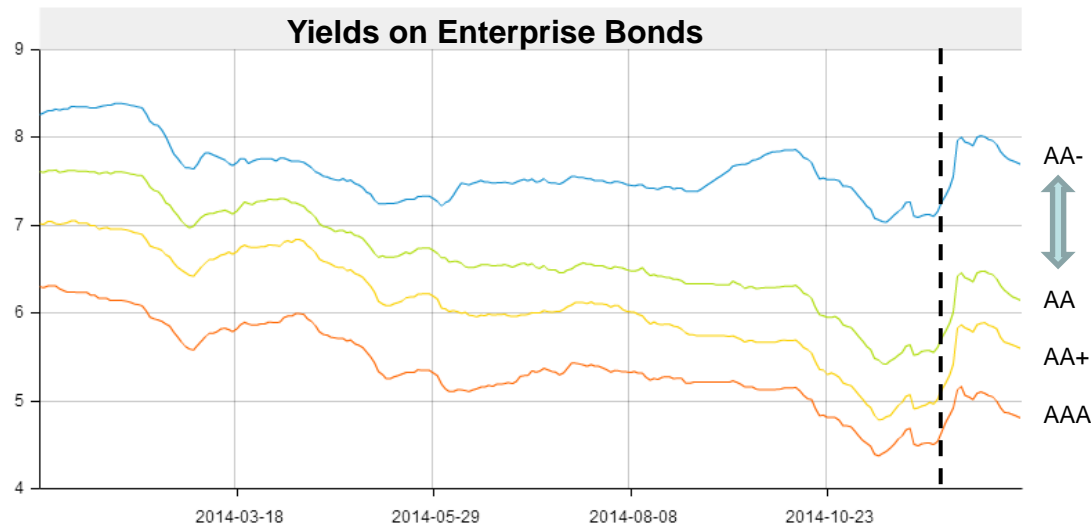
### Selected Credit Events in 2014

Issuer	Amount	Event
Shanghai Chaori Solar Energy Science & Technology Co.	RMB 89.8 million interest	Default, received guarantee and fully repaid
Huatong Road & Bridge Group	RMB 429 million principal and interest	Not default, repaid with coordination of the local government

# RMB Bond Market – Onshore

## Credit Risk: Credit Spread

- The market requires additional risk premiums for low-graded issuers. The credit spread between AA rated and AA- rated bonds has been widening since the second half of 2014.
- In December 2014, the clearing authority announced a new guideline on repurchase agreements. Bonds rated below AAA or issued by issuers below AA are no longer used as collateral. This has resulted in an immediate increase in bond yields.
- Widening in credit spread is likely to continue in 2015.



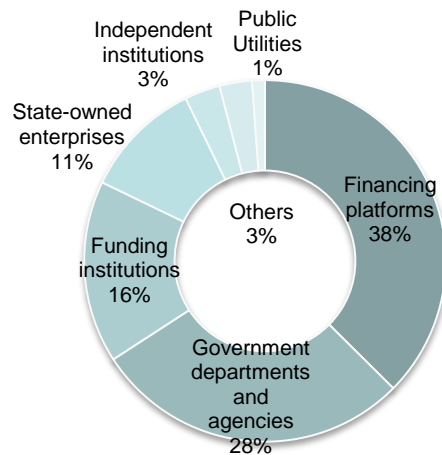
Source: Chinabond

# RMB Bond Market – Onshore

## Local Government Debt

- Local governments are facing massive refinancing needs and temporary liquidity pressure. The central government announced plans to enhance the transparency of local government borrowing amid risks.
  - *May 2014* Pilot program approving 10 provinces and cities to issue bonds on their own credit
  - *Aug 2014* Revised Budget Law allowing local government debt issuance within a stringent framework
  - *Oct 2014* New Borrowing Guidelines imposing quotas on local government debt and banning additional borrowing through financing vehicles

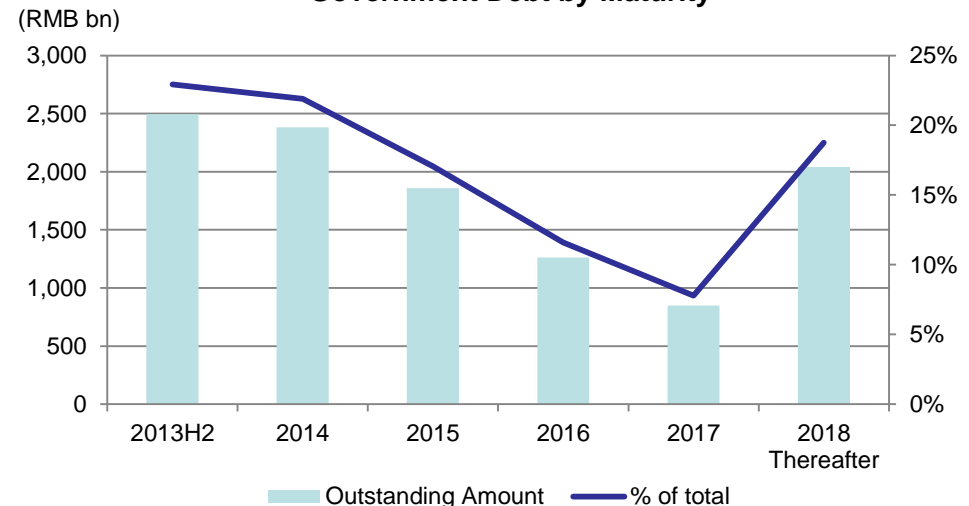
Government Debt by Entity Type



Source: NAO

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Government Debt by Maturity



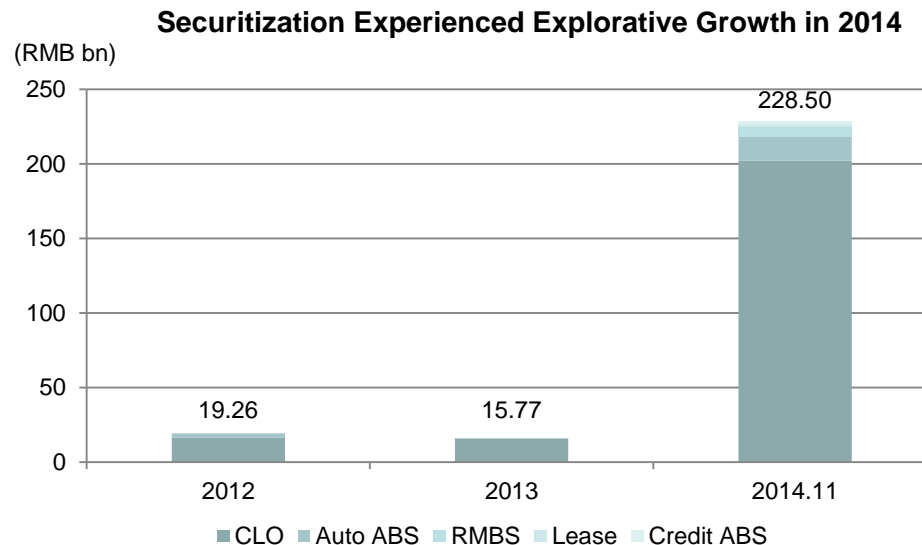
Source: NAO



# RMB Bond Market – Onshore

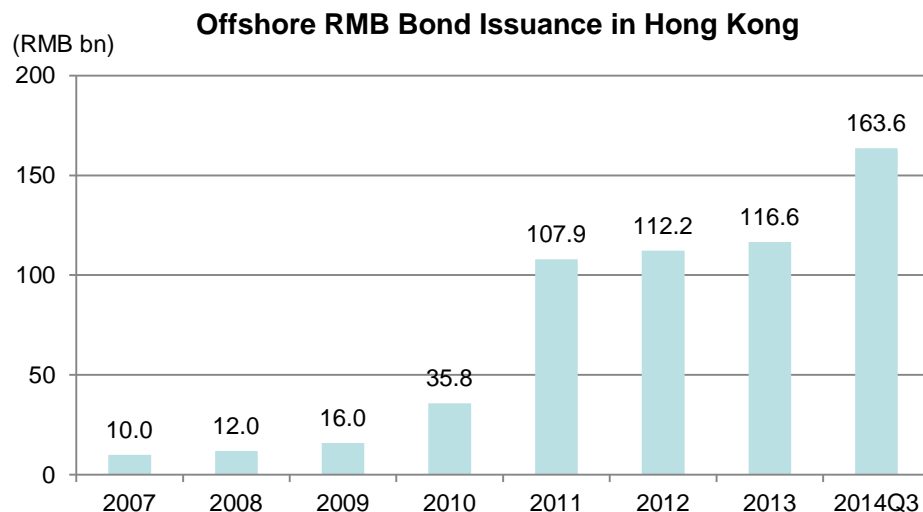
## Securitization

- Since resuming in 2012, securitization has been expanding with increased diversification in asset classes. As of November 2014, 55 securitized products were issued with an aggregate amount of RMB 228.50 billion, including CLO, RMBS, ABS, and leasing.
- In 2015, there will be a rapid growth of securitization in both interbank and exchange markets. We expect products related to leasing, Internet finance, and SME finance will be issued.



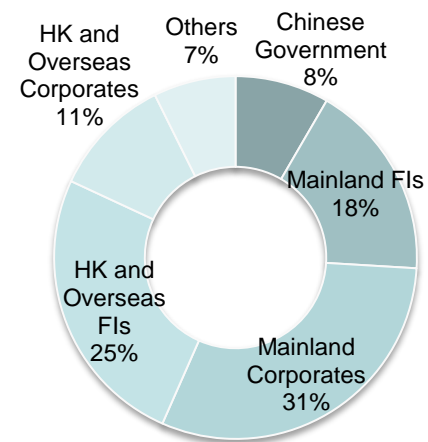
# RMB Bond Market – Offshore

- The trend of internationalization of the RMB and liberalization of capital account facilitates the development of offshore RMB bonds. In Hong Kong, new issuance (excluding CDs) hit a record of RMB 163.6 billion in the first three quarters of 2014, exceeding the annual issuance in 2013. The outstanding amount went up to RMB 374.4 billion.
  - Relaxation of cross-border guarantees and foreign exchange controls gives Chinese companies more flexibility in the offshore markets. We expect issuers with Chinese background will continue to dominate the market.
  - The UK government issued a RMB bond in London in October 2014, becoming the first non-Chinese sovereign issuer. The issuer base will continue to diversify.



Source: HKMA

**2014 Issuance Amount by Issuer Type**



Source: Reuters, CCXAP research





# RMB Internationalization

- According to SWIFT, the RMB has strengthened its position as the seventh-ranked currency in global payments, an all-time record share.
- Seven clearing banks were appointed in 2014, and two were just appointed on January 6, 2015. The number of RMB offshore clearing centres increased to 13.
- With the establishment of Shanghai free-trade zone and pilot programs in other geographic areas, cross-border RMB business has expanded its coverage and recorded volume surge.
- Launched in November 2014, Shanghai-Hong Kong Stock Connect can facilitate outflow and inflow of the RMB, and accelerate the pace of RMB internationalization.

## Offshore Clearing Centres

Appointed Year	Location
2003	Hong Kong
2004	Macau
2012	Taiwan
2013	Singapore
2014	UK, Germany, South Korea, France, Luxembourg, Qatar and Canada
2015	Thailand Malaysia

# Conclusion

- China's economy is under the process of rebalancing. We expect a slower growth of about 7% in 2015. The real economy stagnates, while risks in the financial system remains high. The government is embarking on an detailed implementation program of market reform, which should be able to bring long-term benefits.
- Heading towards further market liberalization, China's domestic bond market is facing the situation of increasing credit risk. As the economy is in its correction, SMEs and some SOEs will encounter challenges in funding and debt repayment. We expect more credit events to occur in 2015.

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